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IN THE

Supreme Court of the United States

OCTOBER TERM, 1968

No. 780

THE FRANKLIN LIFE INSURANCE COMPANY,
Petitioner,

—v.—

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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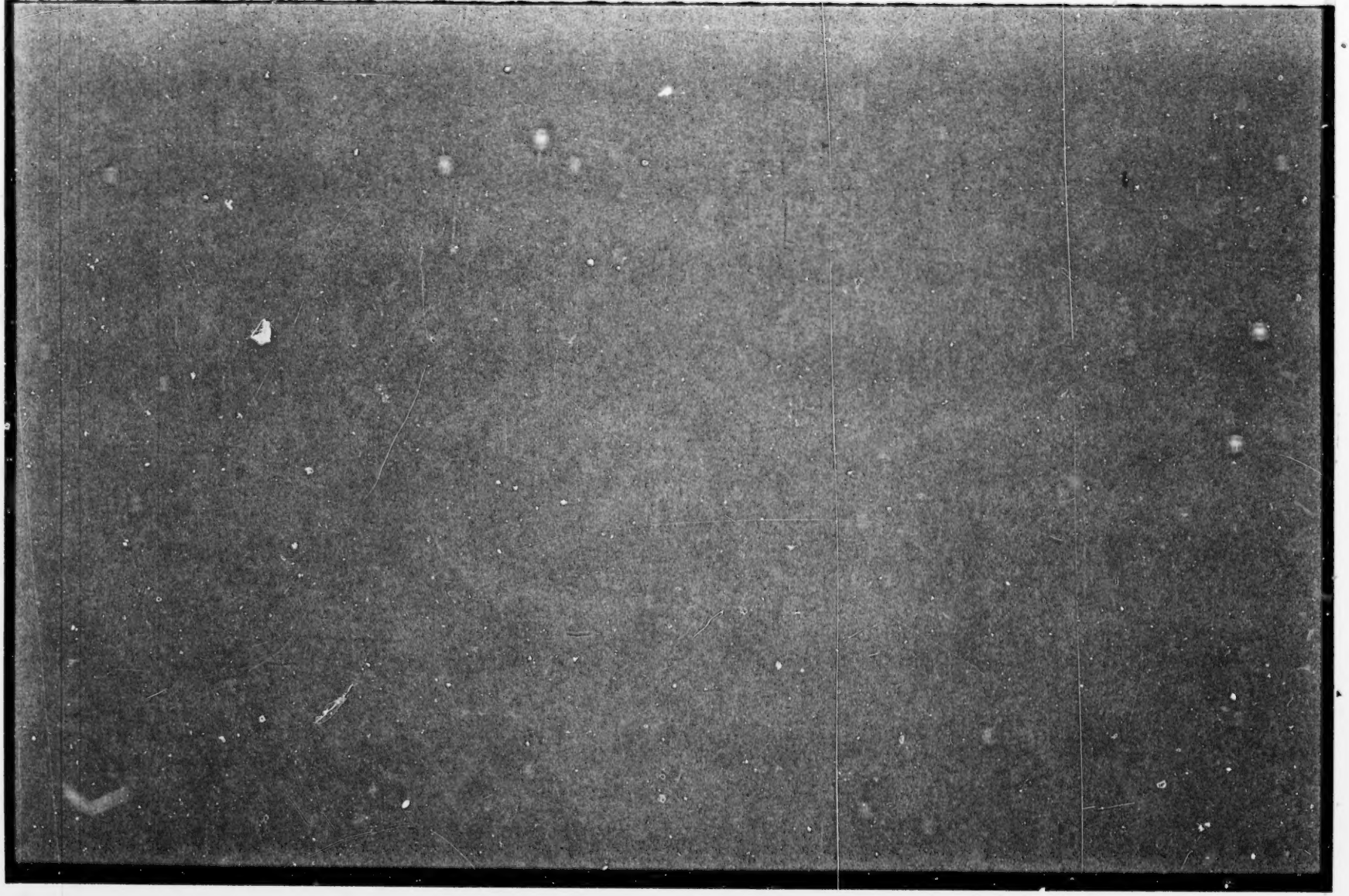

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UNITED STATES OF AMERICA,

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

Petitioner, The Franklin Life Insurance Company, prays that a Writ of Certiorari be issued to review the judgment of the United States Court of Appeals for the Seventh Circuit in the above-entitled case.

OPINIONS BELOW

The opinion of the Court of Appeals is reported at 399 F. 2d 757, and is reprinted as Appendix A hereto, pp. 1a-14a, *infra*. The District Court for the Southern District of Illinois wrote no opinion. Its extensive findings of fact and conclusions of law relative to the issues tendered hereby are set forth in Appendix D hereto, pp. 19a-50a, *infra*.

JURISDICTION

The judgment of the Court of Appeals was entered on July 11, 1968. (Appendix B, pp. 15a-16a, *infra*) A timely Petition for Rehearing was denied on August 30, 1968. (Appendix C, pp. 17a-18a, *infra*) The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1254(1). The basis of jurisdiction in the District Court was 28 U.S.C. § 1346(a)(1) and Internal Revenue Code of 1954, § 7422.

QUESTIONS PRESENTED

1. Whether deferred and uncollected premiums, which a life insurance company has not received and has no right to receive, should be reflected to increase its net income ("gain from operations") under Section 809 of the Internal Revenue Code of 1954 ("Code"), as added by the Life Insurance Company Income Tax Act of 1959.

2. Whether the loading on these deferred and uncollected premiums should be included in the assets of a life insurance company under Code Section 805 for the purposes of computing the taxable share of its investment income.

3. Whether advance interest on a life insurance company's policy loans, which has not been earned within the taxable year, is properly includible in the company's investment income under Code Section 804.

4. Whether capitalized interest on policy loans, which a life insurance company has not earned within the taxable year, is properly includible in its assets under Code Section 805 for the purposes of computing the taxable share of its investment income.

STATUTES AND REGULATIONS INVOLVED

The statutory provisions involved, Sections 801(a) and (b), 802, 804, 805(a), (b) and (c), 809, 810(a), (b) and (c), 811 and 818(a) of the Internal Revenue Code of 1954, as added by the Life Insurance Company Income Tax Act of 1959, and Sections 446(a), (b) and (c) and 451(a) of the Internal Revenue Code, are set forth in Appendix E, pp. 51a-78a, *infra*. Also set forth in Appendix E are the pertinent parts of Sections 1.809-4 and 1.818-2 of the Income Tax Regulations (pp. 78a-82a, *infra*).

STATEMENT

Petitioner is a legal reserve life insurance company. For its taxable years commencing in 1958, it has been subject to the Life Insurance Company Income Tax Act of 1959.[1] The Internal Revenue Service ("IRS") imposed additional assessments against petitioner, on two principal bases, for the years 1958 through 1962. (App. 39-42, Tr. 128-30; App.

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[1] Internal Revenue Code of 1954, §§ 801-820, as added by Public Law 86-69, 73 Stat. 112, as amended. This legislation will henceforth be referred to as the "Act" and statutory section references not otherwise identified herein will be to the Internal Revenue Code section numbers of the Act.

The Act amounted to a "comprehensive overhaul" of the provisions of the Internal Revenue Code affecting life insurance companies. *United States* v. *Atlas Life Ins. Co.*, 381 U.S. 233, 235 (1965). From 1921 to 1958, these companies were taxed only on a portion of their investment income. The Act introduced the concept of taxing life insurance companies on their "gain from operations," the life insurance company equivalent of "net income." It also provided a new set of formulas for allocating investment income between the portion attributable to the policyholders and the taxable portion attributable to the company. For a general discussion of the provisions of the Act, see *United States* v. *Atlas Life Ins. Co., supra,* at 235-36, and n. 2 (1965). See n. 3, p. 21, *infra.*

3-20; App. 353-56)[2] Petitioner paid the assessments and sued in the District Court for the Southern District of Illinois for a refund. The two main bases of the additional assessments and the refund suit, and the two basic questions which are tendered by this Petition, have to do (1) with the treatment of premiums deferred and uncollected as part of petitioner's taxable income and as part of petitioner's assets,[3] and (2) with the inclusion of unearned interest on policy loans in petitioner's income and assets.

1. *Treatment of Premiums Deferred and Uncollected.*— When the anniversary date for a life insurance policy occurs and the entire premium for the coming policy year has not been paid in full, the premium—or the portion thereof—for the coming year which has not been paid is called "deferred and uncollected" or, in certain cases, "due and uncollected." (App. 77, Tr. 206, pp. 31a-32a, *infra*)

There can be two reasons why the full annual premium has not been paid on the anniversary date. The first reason is that only a part of the year's premium was payable on the anniversary date, and the rest, pursuant to the terms of the policy, is payable during the course of the ensuing year on a semiannual, quarterly, or monthly basis. Under these circumstances, only the semiannual, quarterly, or monthly premium payable on the anniversary date would have been received, and the remaining portion of the year's

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[2] References to the appellant's (respondent here) Appendix in the Court of Appeals will be denoted as "App." and to the manuscript record as "Tr."

[3] The amount of petitioner's assets is relevant to one of the computations performed under the Act, namely, the determination of the shares of investment income which are allocable to policyholders, on the one hand, and to the company (and, hence, taxable), on the other. This allocation, very generally speaking, depends on the ratio of liabilities to policyholders on the one hand to total assets on the other hand. See generally §§ 804-05, pp. 56a-64a, *infra*.

premium would be "deferred and uncollected." The second reason is that the premium has become payable—sometimes loosely called "due"—in whole or in part, but that the policyholder has not paid it. As long as the policy remains in force although the premium payment is "due" and unpaid on it—as would be the case during the usual 30-day "grace periods" which are included in policies under state law or company practice—the premium in question would be "due and uncollected."[4] (App. 120-21, Tr. 9[illegible]

In either case, the insurance company has no right to collect the "deferred" or "due" portion of the premium, and in fact will never have any such right. (App. 79, Tr. 207, p. 33a, *infra*) Indeed, life insurance policy premiums never become "due" in any real sense—such as the sense that a mortgage payment becomes due. A life insurance policy is a classic example of a unilateral contract; all the legally enforceable obligations run in one direction—from the insurance company to the persons having an interest in the policy. The payment of the stipulated premiums is not a duty; it is simply a condition precedent to the life insurance company's obligations to provide coverage.

In order to comply with the requirements of the insurance regulatory authorities in the states in which it does business, petitioner makes up its financial statements on certain forms promulgated by the National Association of Insurance Commissioners ("NAIC").[5] (App. 62-63, Tr.

[4] For the remainder of this Petition, we shall generally refer to both premiums "deferred and uncollected" and "due and uncollected" as "deferred and uncollected" for the sake of brevity.

[5] The NAIC is a national organization composed of the officials of the several states who are charged with supervision of insurance companies and their operations. The NAIC was organized in 1871. Soon after its organization the NAIC adopted

183-84; App. 74-76, Tr. 204-05, pp. 28a-30a, *infra;* App. 111-13, Tr. 78-80) The statement forms prescribed by the NAIC have long[6] imposed a requirement on petitioner to take into account as a liability the coming full policy year's legal reserve[7] on all policies whose anniversary date has occurred during the calendar year ending on date of the statement. The forms also require petitioner to take as a deduction in computing its net income—or, as the NAIC statement calls it, its "gain from operations"—the amount by which its total reserve liabilities at the end of the year exceed the corresponding figure at the beginning of the year. (App. 79, Tr. 207, pp. 33a-34a, *infra;* App. 115, Tr. 83)—As indicated, these reserves include the full annual reserve increase in respect of policies on which a portion or all of the annual premium remains deferred and uncollected.

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a uniform annual statement form and related instructions, and life insurance companies have filed their annual statements since then on the forms from time to time adopted by the NAIC. (App. 74-75, Tr. 204, p. 28a, *infra*)

[6] This requirement appears in the current (1951) revision of the forms and, indeed, first appeared in 1873. (App. 119, Tr. 89; App. 338, Tr. 536) Hence, it long predates the Act.

[7] The "legal reserve" consists of "that fund which, together with future premiums and interest will be sufficient to pay future claims." *United States* v. *Atlas Life Ins. Co., supra,* at 236, n. 3. Another definition is that it consists of an amount which is computed on the basis of a recognized mortality table and assumed rates of interest which is set aside to mature or liquidate future unaccrued claims arising from life insurance and annuity policies and contracts involving life contingencies. (See § 801(b)(1), pp. 51a-52a, *infra.*) The "full year's" legal reserve is the total amount required to be added to the reserve increase with respect to a given policy in respect of that policy's continuation for the entire year subsequent to the anniversary date in question. That increase includes a full year's *net* premium—loading (see n. 9 p. 7 *infra*) is not included and plays no part whatsoever in the reserve increase. Inasmuch as this full annual amount is required by state law (see § 801(b)(2), p. 52a, *infra*), it is also included in taxpayer's liabilities for computing its taxes under the Act as of the anniversary date in question.

Obviously, this inclusion of the reserve liabilities with respect to premiums deferred and uncollected, in and of itself, would have the effect of introducing charges against the company's income and making it less than what it would otherwise have been. However, the NAIC form then proceeds to "wring" out of the income statement the effect of including these particular reserve liabilities by including an offsetting, balancing factor against them. This factor is called the net valuation premium; it consists of the *full amount* of the deferred and uncollected premiums *offset* by the so-called *"loading"* on these premiums.[8] This factor exactly balances the particular reserve liabilities in question. Thus, the net effect is exactly to cancel out the effect of including these charges against income; it is the same as if the increase in the reserve liabilities in respect of the premiums deferred and uncollected had not been included in the NAIC form as a charge against income in the first place.[9]

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[8] Since this computation is for making up the "income" or "gain from operations" account and not a balance sheet computation, what actually is done is to "wring" out the *increase* of this amount at year end over the amount at the beginning of the year. Similarly, the amount of reserves which are correspondingly "wrung" out from the debit side of the equation is the *increase* of reserves in respect of premiums deferred and uncollected as of the end of the year over the amount at the beginning of the year.

[9] As suggested, the calculation is essentially circular. The two figures which are offset against each other to produce the factor which "wrings" out the increases in reserves attributable to premiums deferred and uncollected are called (1) the "gross annual premiums deferred and uncollected," which is the whole amount of the deferred and uncollected premiums and (2) the "loading" thereon—also defined as the excess of the gross annual premium over the "net annual valuation premium."—The "net annual valuation premium," to complete the circle, is the amount of premium needed each policy year to be passed to the reserve in order to maintain the reserve. (App. 77, Tr. 205-06, pp. 31a-32a, *infra;* App. 116,

In computing its income tax, petitioner did not reflect in its net income ("gain from operations") the deferred and uncollected portion of the premiums for the coming year on policies whose anniversary date had come by the end of the taxable year.—As indicated above, these premiums had not been received, there was no right to receive them at the close of the taxable year, and some of them would not even be payable by the policyholders for as long [redacted] the NAIC form, also, these deferred and uncollected

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Tr. 84-85) Thus, the formula amount which is offset against the increase in reserves with respect to premiums deferred and uncollected in order to "wring" them out is the increase in net annual valuation premium attributable to premiums deferred and uncollected, which is derived by subtracting the applicable "loading" from the "gross annual premiums deferred and uncollected." As is evident, this circular computation simply takes one back to where he would be if the reserve liabilities with respect to premiums deferred and uncollected had not been included as a deduction from income in the first place. Quite understandably, this procedure has been criticized as "unnecessarily clumsy. A much simpler method and one that would be more intelligible to the general public would be to deduct the aggregate amount of the actuarial net premiums (which were uncollected and deferred) directly from the aggregate amount of reserves calculated according to the established method before entering the reserve liability in the Annual Statement." Wightman, *Life Insurance Statements and Accounts* (1952), pp. 45-46.

The computation may be illustrated by reference to certain of the lines in the NAIC form, a copy of which is in the record as Jt. Ex. 25. The NAIC form (page 4, "Summary of Operations") takes as a deduction the entire increase in the legal reserve, including the portion attributable to premiums deferred and uncollected (line 17). Against this are offset as a positive item the gross amount of premium income accrued, *plus* the increase in the gross amount of premiums deferred and uncollected (line 1) and as a negative item the increase in loading on premiums deferred and uncollected (line 25). The net effect is thus to cancel out the factor, included as a charge against income, for the increase in reserve liabilities with respect to premiums deferred and uncollected.

premiums are not reflected in petitioner's gain from operations.[10]

Nonetheless, the IRS required petitioner to reflect in its income for each taxable year the full amount of deferred and uncollected premiums. The IRS thus required petitioner to pay a tax based on the assumption that the *gross* amount—including loading—of these deferred and uncollected premiums had in fact been received on the anniversary date of the petitioner's policies.

Similarly, in computing petitioner's assets for one of the special computations applicable to Federal income taxation of life insurance companies—a computation in which an increase of assets as compared to liabilities to policyholders would result in increasing petitioner's taxes[11]—the IRS required petitioner to include as an asset the gross amount of the deferred and uncollected premiums with respect to policies whose anniversary dates had occurred during the taxable year.—In its computation of its assets and liabilities petitioner had followed state insurance law and the NAIC form; these require petitioner to include as a liability the full annual legal reserve on all its policies for the year following their anniversary date—including the portion relating to deferred and uncollected premiums

[10] The only real issue with respect to this aspect of the matter is whether the "increase in *loading* on premiums deferred and uncollected" is to be included in income. The inclusion of the net valuation premium is immaterial, since it simply cancels out the charge for the reserve in respect of premiums deferred and uncollected, and does not cause any plus or minus reflection of premiums deferred and uncollected in net income ("gain from operations"). Thus, it is appropriate to characterize the issue in question either as being whether premiums deferred and uncollected should be reflected in the taxpayer's net income, or whether the increase in loading on such premiums should be included in the taxpayer's income.

[11] See n. 3, p. 4, *supra*.

—and to include as an offsetting asset the amount of deferred and uncollected premiums net of loading (the so-called "net valuation premium").[12] This offsetting asset is in an amount which exactly cancels out the liability attributable to the legally-required inclusion in the reserves of that portion of the reserves attributable to premiums which were deferred and uncollected at year end. (App. 85-86, Tr. 211-12, pp. 40a-41a, *infra;* Jt. Ex. 25, pp. 2-3; App. 129-30, Tr. 103-04)

2. *Unearned Advance Interest on Policy Loans.*—Those of petitioner's life insurance policies which have cash values provide that a loan may be made upon the sole security of the cash value of the policy. The policies provide for the payment of interest on these loans—generally at the rate of five percent—payable annually in advance. If the policyholder repays the loan before the end of the year for which interest has been paid (or if his policy terminates at maturity or by death, causing a liquidation of the loan by an offset against the policy proceeds), the unearned portion of the interest is credited to him pro rata. (App. 88, Tr. 214, pp. 43a-44a, *infra;* App. 269-70, Tr. 391-92)

When a policyholder who has a loan does not pay interest thereon when due—for example, the annual advance interest payable at the beginning of the second year of the loan —the amount of the year's interest not paid is added[1] to the principal of the loan. (App. 280, Tr. 405-06; App. 91, Tr. 216, p. 46a, *infra*) However, if the loan is repaid or otherwise retired before the end of the year for which the capitalized interest has been added to the policy loan, the

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[12] See n. 9, p. 7, *supra.*

[1] If the cash value of the policy will support it.

pro rata share of the unearned interest so capitalized is credited to the policyholder. (App. 91, Tr. 216, p. 47a, *infra*)

Petitioner included in income only that portion of advance policy loan interest which was in fact earned during the taxable year. Thus, in the case of a policyholder charged $50 annual interest on July 1 with respect to [redacted] of the interest would be earned by December 31, and if the loan were repaid on that date, the other $25 would have to be credited to the policyholder. Accordingly, petitioner would only include $25 in income with respect to the policy loan interest for the year indicated. Similarly, in the case of capitalized interest added to the principal of a policy loan balance, petitioner included in its assets, for the purposes of the computations under the Act to which asset amounts are relevant, only the portion of the capitalized interest which had been earned by the year end. Both these aspects of the treatment of advance interest agreed with the accrual method in which petitioner regularly kept its books and with the treatment given the items in question in the NAIC forms.[2] (App. 91-92, Tr. 216-17, pp. 46a-48a, *infra*)

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[2] The computation is made in Exhibit 3 to the NAIC form. Line 5 of this Exhibit relates to "interest on premium notes, policy loans and liens"; actually, the only significant item currently reported in this line is "interest on . . . policy loans". From the amount "collected during the year" (column 1) is subtracted the "unearned" amount (column 2) and to the remainder is added the amount due at the close of the year (column 3). After appropriate adjustments for the previous year's interest, the remaining amount is the amount "earned during year" which is then passed to Exhibit 2, together with the total of other items of investment income, for the subtraction of appropriate expenses and the computation of net investment income, which is, in turn, transferred to line 4 of the Summary of Operations as "net investment income."

Nonetheless, the IRS assessed a deficiency against petitioner. The IRS took the position that petitioner should include in income the entire amount of interest received in advance in the year in which it is received, notwithstanding that a portion of it was not earned during the year in question and would have to be paid back if the loan were paid off. It also took the position that petitioner should include the full amount of capitalized policy loan interest in its assets, notwithstanding that a liability existed to credit the unearned portion of this sum back.

* * * * *

After the receipt of stipulations and a full evidentiary hearing, the District Court held for petitioner on both sets of issues. It held that inasmuch as petitioner had no legal right to collect deferred and uncollected premiums, the increase in loading on deferred and uncollected premiums should not be included in taxable income and the loading should not be included as an asset. (App. 82, 84, 85-87, Tr. 209, 211-13, pp. 36a-37a, 39a-43a, *infra*) It also held that inasmuch as the advance interest was earned only ratably day by day, and since the policyholder had the right to pay off a policy loan at any time and receive a refund of the unearned interest pro rata, the advance interest paid or capitalized on policy loans should not be included in petitioner's income or assets until earned. (App. 88-94, Tr. 214-18, pp. 43a-50a, *infra*) Judgment was entered in favor of petitioner for a total of $1,303,011 in taxes and interest, of which $1,249,184 represented the taxes and interest relating to the issues stated above.[3] The respondent appealed from the judgment of the District Court to the Court of Appeals for the Seventh Circuit with

[3] Certain other issues raised by the complaint were settled by the parties and included in the judgment or were determined by the District Court and not appealed by the respondent.

respect to the issues stated above, and the Court of Appeals reversed the judgment of the District Court on these issues.

REASONS FOR GRANTING THE WRIT

A. *The Issues Respecting Premiums Deferred and Uncollected*

1. *The Questions Are Substantial.*—By the decision of the court below, for what is believed to be the first time in the history of the Federal income tax laws, amounts which a taxpayer has not received and which he has no right to receive have been included in his income and he has been made to pay a tax on them. Previously, under settled principles of tax accrual accounting, it had been uniformly considered that inclusion of an amount in income takes place only upon the earlier of the arising of the right to receive it or the actual receipt of it. See *Schlude* v. *Commissioner,* 372 U.S. 128, 133 n. 6, 136-37 (1963), and cases cited; *Commissioner* v. *Hansen,* 360 U.S. 446, 463-64 (1959). The decision of the court below goes far beyond what has been judicially considered income,[1] and its reasoning is completely without support in the text or history of the statute or in the settled principles of tax accrual accounting.

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[1] The ruling also goes beyond the concept of "income" in popular speech—and hence, the concept of income in the Constitution, whose Sixteenth Amendment uses the word "income" in the popular sense. See *Eisner* v. *Macomber,* 252 U.S. 189, 206-07 (1920). This question presented in the case—as did the question in *United States* v. *Atlas Life Ins. Co.,* 381 U.S. 233 (1965)—accordingly raises issues of Constitutional significance. See the Government's Petition for Certiorari in the *Atlas Life* case, pp. 12-15, where it was pointed out that in the context in which the question involved in that case arose, the statutory and Constitutional questions coalesced. The *Atlas Life* petition is believed to be the only petition for certiorari involving an issue under the Act tendered to this Court prior to this one. Certiorari was granted.

The ruling of the court below requires the gross amounts of premiums deferred and uncollected, including loading, to be reflected in income; and of course it requires they be taken into account without deduction for commissions and other expenses chargeable against that loading, since those commissions and other expenses have not yet accrued and will not accrue until the premiums are paid.[2] In the light of the industry-wide experience (see pp. 20-22, below) of substantial annual increases in loading on premiums deferred and uncollected—with the corresponding expenses not incurred until the year in which the premium is actually received—the decision below will have the effect of making a permanent overstatement of the real income of life insurance companies.

The holding of the court below finds no support in the text of the statute. The Act requires the inclusion in income of:

> "Premiums.—The gross amount of premiums and other consideration (including advance premiums, deposits, fees, assessments, and consideration in respect of assuming liabilities under contracts not issued by the taxpayer) on insurance and annuity contracts (including contracts supplementary thereto) . . . ." (Section 809(c)(1), p. 67a, *infra*.)

The statute expressly includes advance premiums, and makes no mention of premiums deferred and uncollected. Against the backdrop of tax accrual accounting required as to life insurance company taxation (see Section 818(a), p. 77a, *infra*), it is clear that this statutory language includes only the gross amount of premiums which the tax-

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[2] The petitioner's position is simply that premiums should be reflected in income when received and the related deductions for commissions and the like then taken.

payer has received during the course of the year or those (if any)[3] with respect to which its right to receipt matured during the year. Premiums, after all, are the amounts paid for life insurance coverage. There is not a word of support in the legislative history—and neither the court below nor the respondent in arguing before it pointed to any—for reflecting in income deferred and uncollected premiums—premiums which the taxpayer has not received and has no right to receive and for which it has not yet provided coverage.

The only support in the authorities for the holding of the court below was the IRS' own regulation, promulgated in 1961, which reworked the provision of the statute quoted above by inserting in it the words "premiums deferred and uncollected and premiums due and unpaid." See Regulations 1.809-4(a)(1)(i) p. 79a, *infra*.[4] As indicated below (pp. 24-25 and nn. 13 and 14, pp. 24 and 25), the promulgation of that regulation simply created the industry-wide controversy with the IRS as to which this case furnished the first appellate adjudication.

The holding of the Court of Appeals is apparently based on three assumptions: *First,* that the taxpayer had con-

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[3] There are evidently a few unusual forms of life insurance policies, in the group area, which do give rise to an account receivable when the premium becomes "due." See Nash, *Taxation of Life Insurance Companies* (1968), § 17.04. This form of policy is not involved in this case; only the conventional policy on which payment of the premiums never amounts to a legal obligation.

[4] Thus, the regulation provides that the term "gross amount of all premiums" "includes advance premiums, *premiums deferred and uncollected and premiums due and unpaid,* deposits, fees, assessments and consideration in respect of assuming liabilities under contracts not issued by the taxpayer. . . ." The italicized words are the words which the IRS added to the statutory language quoted in the text at p. 14 above.

ceded a keystone point in the case (see p. 7a, *infra*); *second,* that the taxpayer was contending for a *deduction* for the loading on premiums deferred and uncollected, a deduction no provision for which the court found in the statute (see p. 7a, *infra*); and *third,* that the basic issue in the case was whether the NAIC form was somehow sacrosanct and took precedence over the principles of Federal tax law which might have been thought otherwise to apply.[5] (see pp. 6a-7a, *infra*)

These three assumptions are all manifestly erroneous. —In the first place, petitioner has never taken any position other than that Section 809 does not require the inclusion in gross income of deferred and uncollected premiums.[6]

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[5] The court below also apparently accepted (see pp. 7a-9a, *infra*) the respondent's argument that inasmuch as, on the debit side of the petitioner's statement of operations, the reserve increase relating to premiums deferred and uncollected is taken into account, as required by state law (and hence by Section 801(b)(2)), it was somehow only fair to take into account the gross amount of the premiums deferred and uncollected as an income item, although there was no right to receive them.—The Government conceded in the court below that if it were not for the inclusion of the reserve liabilities, the premiums deferred and uncollected could not be taken into income. (Gov't Br., p. 35)

But this argument is clearly incorrect. As indicated above (p. 7), the petitioner (and the NAIC statement form) proceed precisely to cancel out the inclusion of the reserves allocable to premiums deferred and uncollected by making a balancing entry of the allocable net valuation premium on the credit side of the equation. If it is supposedly fair, because the reserve has been included for computational purposes, to include the gross premium deferred and uncollected in income (even though under accrual principles its inclusion would admittedly be unthinkable), the respondent never has pointed out why it would not also be just as fair to introduce the unaccrued related expenses involved in collection, commissions, and the like, with respect to the gross premiums deferred and uncollected. For it is only "[A]s the deferred premium is collected in gross, [that] expenses are accrued in relation thereto and income and profit is reflected." Nash, *Taxation of Life Insurance Companies* (1968), § 17.06, at p. 17-11.

[6] See the Petition for Rehearing below, pp. 1-2.

Secondly, the court below erred when it characterized the issue here as whether there was a statutory deduction for increase in loading on deferred and uncollected premiums.[7]—The court, quite understandably, failed to find any such express deduction; of course, the reason is that Congress never contemplated that such an amount—which the taxpayer neither has received nor has the right to receive—would be reflected in income in the first place. As indicated above, there is not a shred of support in the statute or the legislative history for the inclusion of such an amount in income; and under any principle of tax accrual accounting its inclusion would be unthinkable.[8]

Thirdly, the Court of Appeals erroneously assumed that the basic question in issue was whether the NAIC form, or tax accrual accounting, was governing. But the fact of the matter is that under *no* concept of tax accrual accounting have items such as those at issue here ever been included in gross income before or can they be so included. The further, and paradoxical, fact is that it was the court below, not petitioner, which was led astray by the peculiarities of the NAIC form. The court labored under the misconception that use of the formula which the NAIC follows in order to "wring out" of income the

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[7] The District Court did not find that what was involved here was a deduction, but simply a question of the proper amount to offset against the reserve liabilities. See Conclusion of Law 2, App. 84, Tr. 211, p. 39a, *infra*.

[8] If, however, it could be said that the gross premiums deferred and uncollected were somehow accruable and includible in income, it would appear that there would be a statutory deduction for the loading on them. That deduction is the deduction provided life insurance companies for reserves for unearned premiums. See Section 810 (c) (2), p. 75a, *infra*. However, we of course need not go this far; the basic position of petitioner is simply that it is improper to reflect premiums deferred and uncollected in net income at all by taking the loading on them into income.

effect of including the reserve requirements in respect of premiums deferred and uncollected—the offsetting of the gross amount of premiums deferred and uncollected against the applicable loading to produce a net figure to cancel the effect of including the reserve liabilities for those premiums (see p. 7, *supra*)—somehow amounted to an attempt to take a deduction unauthorized by law. But, as developed above, this case does not involve the question whether the NAIC form can authorize a deduction not contemplated by Congress, but the question whether the loading on premiums deferred and uncollected is includible in income in the first place.[9]

The decision of the Court of Appeals, accordingly, on this issue is so lacking in authority, so manifestly without support in the statute, and so patently out of line with normal tax accrual accounting principles, as to suggest the need for review by this Court—even apart from the fact, as we develop at pp. 20-29, below, that the issue involved is of enormous industry-wide importance.

Similarly questionable is the Court of Appeals' related holding that the gross amount of deferred and uncollected premiums, including loading, was includible in petitioner's assets for calculating the policyholders'-liabilities-to-assets ratios which figure in the computation of certain

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[9] The only secondary, let alone primary, authority cited by the court below in support of its conclusion is a passage from Wightman, *Life Insurance Statements and Accounts*. See p. 8a, *infra*. But an examination of the pages cited makes it clear that what the court below was referring to was the recommendation of an industry committee that these amounts be treated as accrued income and assets, which recommendation the NAIC rejected; and, in Wightman's view, correctly. See *id.*, at p. 45. The conclusions of Wightman's treatise are in accord with our position. Thus, he indicates (p. 374) that inclusion of the loading on deferred and uncollected premiums in income would amount to an overstatement of income. See also n. 9, p. 7, *supra*.

aspects of petitioner's income taxes. The Tax Court has recently decided this very issue in flat conflict with the decision of the Court of Appeals. *Western National Life Ins. Co.*, 50 T.C., No. 28, May 13, 1968, CCH Tax Ct. Rep. ¶28,954. As the Tax Court trenchantly observed:

> "The ready and simple answer to whether these items can be 'assets' is that they have no existence as an asset . . . There being no liability upon the policyholders to make any premium payments, there can be no justification for their accrual. Absent an accrual in this situation, only resort to mediaeval metaphysics could translate the items in question into 'assets'." CCH Tax Ct. Rep., at p. 2427.

The Court of Appeals did not, as to its inclusion of these items in assets, have even the benefit of its erroneous assumption that the exclusion of these items somehow involved an unauthorized deduction. The NAIC form itself on this point does not go through the two-step process—which apparently confused the court with respect to the issue of inclusion in income—of netting the loading against the gross amount of premiums deferred and uncollected in order to produce the number which will "wring out" the reserve liabilities with respect to the premiums deferred and uncollected. (See pp. 7, 9-10, 17-18, *supra*) The form simply includes directly the net valuation premium on the premiums deferred and uncollected—the amount net of loading—in order to match and cancel out the reserve liability on the premiums deferred and uncollected.

The approach of the IRS here, sanctioned by the court below, requires the inclusion in assets of the gross premiums deferred and uncollected, which have not been

received and which are not receivable, notwithstanding that simultaneously upon the receipt of these premiums they will be burdened by liabilities, such as commissions payable, which will match them in whole or in part—liabilities which the petitioner is, of course, not permitted to accrue. Here again, the Court of Appeals' decision, even apart from its overwhelming importance to the industry, is so absolutely without foundation in authority and so out of line with normal tax accrual principles as to warrant this Court's review.

2. *The Questions Are of Great Public Importance.*—(*a*) The Court of Appeals held, in effect, that the annual increase in loading on deferred and uncollected premiums must be included in the net income of life insurance companies. The figures published by the Institute of Life Insurance of the amounts reflected for this increase in loading item[1] on the annual statements of all the approximately 1,200 life insurance companies in the United States which reported to it[2] were, for the three most recent years for which figures are available, as follows:

1964	*1965*	*1966*
$52,600,000	$76,200,000	$84,600,000

[1] The item in question is a line item in the NAIC form. (Jt. Ex. 25) See n. 9, p. 8, *supra*. Line 25 of the "Summary of Operations" of the NAIC form is captioned "Increase in Loading On and Cost of Collection in Excess of Loading On Deferred and Uncollected Premiums." The Institute of Life Insurance collects and publishes industry-wide figures for the various line items in the Summary of Operations and Statements of Assets and Liabilities in the NAIC form.

[2] There are approximately 1,700 life insurance companies in the United States. Institute of Life Insurance, *Life Insurance Fact Book* (1968), p. 95. However, the approximately 1,200 companies reporting to the Institute of Life Insurance are believed to account for virtually all of the companies writing any active volume of business.

These amounts, accordingly, on the IRS' theory, adopted by the Court of Appeals here, would be includible in income to the industry as a whole for the years in question if the opinion of the Court of Appeals is followed. We believe that it is the position of the entire industry that such amounts are not properly includible in income and that virtually the entire industry has taken this position in computing its income taxes under the Act. (See the responses to questionnaires discussed at pp. 27-28, *infra*)

We do not mean to imply that the annual amount of the tax effect of this aspect of this issue on the industry as a whole may be determined simply by applying the corporate tax rates to the above figures.[3] Thus, because they are "owned" by their policyholders and accordingly tend to pay out substantial amounts to them, the mutual life insurance companies, by taking advantage of the deduction for policyholder dividends, tend in

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[3] As indicated above (n. 1, p. 3), the basic approach of the Life Insurance Company Income Tax Act (see generally Section 802(b), p. 55a, *infra*, and the discussion in the *Atlas* case, 381 U.S., *supra*, at 235-38) is to impose a tax at the ordinary corporate rates on the sum of:

1. Taxable investment income (that is, the so-called "company's share," as contrasted with the "policyholders' share," of investment income) or, if smaller, the gain from operations (but for this purpose there are not permitted as deductions from the gain from operations dividends paid to policyholders and certain other special deductions to the extent that the same would cause the gain from operations to be reduced below a "floor" of taxable investment income less $250,000) (Section 809(f), p. 73a, *infra*); plus

2. If gain from operations (computed with the full deduction for dividends paid to policyholders) exceeds taxable investment income, an amount equal to 50 percent of such excess; plus

3. The amount withdrawn from the policyholders' surplus account for the taxable year. Generally speaking, the "policyholders' surplus account" consists of the initially untaxed 50 percent of the excess of gain from operations over taxable investment income, plus certain other amounts, including the special deductions referred to in item 2, above. (Section 815(c))

many cases not to have an excess of gain from operations over taxable investment income.[4] For the reasons just stated in the margin, this tends to diminish the impact of the inclusion of the loading on premiums deferred and uncollected on them. However, even excluding *all* mutual companies, the estimated[5] industry-wide totals for *stock company* members reporting to the Institute of Life Insurance, of the increase in loading on deferred and uncollected premiums in any given year, still yields a most substantial rock-bottom figure. These estimated figures for the three years are as follows:

1964	*1965*	*1966*[6]
$11,200,000	$16,200,000	$18,000,000

The annual amount at stake on this aspect of the deferred and uncollected premium issue thus appears to lie somewhere between the maximum and minimum figures set forth above.

(*b*) There is more; namely, the effect of the inclusion of the loading on the deferred and uncollected premiums

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[4] See Harman, *The Pattern of Life Insurance Company Taxation Under the 1959 Act,* 15th Ann. Tulane Tax Instit. 686, 719 (1965).

[5] The estimate has been prepared by taking the industry-wide figure and dividing it between mutual companies and stock companies in the ratio indicated by an individual analysis of the hundred largest U. S. companies. These hundred companies in and of themselves account for approximately 85% of the industry-wide figures.

[6] Since most of the stock companies have a gain from operations in excess of their taxable investment income, it would follow that, generally speaking, 50 percent of the amounts indicated above for the years in question would be immediately taxable to them at the ordinary corporate rates—even if no amounts were taken into account for the mutual companies—and the remaining 50 percent would be taxable at the ordinary corporate rates to the extent it was ultimately distributed to the stockholders, and under certain other circumstances.

as an *asset*. This inclusion, ordered by the court below, affects *all* life insurance companies, mutual and stock alike. This is because the amount of the assets of the companies, taken as a comparison with their liabilities to policyholders, is used to determine the portion of their investment income taxable as the "company's share." The amount taxable as taxable investment income is not (as is the amount of gain from operations taxable as such) subject to reduction (other than in a nominal amount) by dividends paid to policyholders;[7] and accordingly, mutual companies are as much affected by this question as are the stock companies.

Here, the figures are of staggering size. It is estimated that for the industry as a whole the total amount of loading on premiums deferred and uncollected as of December 31, 1966, the latest date for which pertinent statistics are available, is $830,000,000.[8] In their annual statements,[9] as well, it is believed, as in their computations for tax purposes,[10] the 1,700 life insurance companies in the United States do not include this amount in their assets.

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[7] See n. 3, p. 21, *supra*.

[8] To derive this figure, the published industry-wide figure of $3,269,000,000 of net due and deferred premiums as of December 31, 1966, was first taken. A study of the hundred largest U. S. companies (which in themselves accounted for 85% of this figure) was made, which indicated the ratio between the loading on the due and deferred premiums (shown as line 17 of Exhibit 13 on the NAIC forms for these companies) and the net due and deferred premiums. This ratio was then applied to the published industry-wide figure.

[9] As indicated above (pp. 9-10), the NAIC form shows the figure for the premiums deferred and uncollected on the basis of the net valuation premium, that is, net of loading. See line 17 of the table of "Assets" in the form (Jt. Ex. 25); see line 17 of Exhibit 13 to the NAIC form, which separately displays the excluded loading and the amount carried to line 17 on the Assets table.

[10] See Schmuck, *Current Problems in Insurance Company Taxation Under the 1959 Act*, 15th Ann. Tulane Tax Instit. 759, 772-73

The effect of the decision of the court below is to require the inclusion *annually* of this enormous amount, not representing any item received or receivable—and of course without any offsetting liability for related costs[11]—in the assets of life insurance companies, and thereby to create a great proportionate increase in the amount of their investment income which is allocable to the taxable "company's share."

(*c*) Moreover, just the few years covered by the foregoing tabulations and figures fall far short of telling the entire story with respect to the importance of this issue. For the well-known fact of the matter is that in the life insurance industry, very few taxable years even commencing on January 1, 1958, the effective date of the Act, and for very few companies, are now "closed" for income tax purposes.[12]

From the earliest days of the Act, a number of controversial industry-wide issues were apparent. The regulation in question, purporting to include in income and assets loading on premiums deferred and uncollected, was promulgated in 1961 and was immediately controversial.[13] The question of the includibility of these items was quickly recognized as one of the basic "national" issues

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(1965). See the responses to questionnaires discussed at pp. 27-28, *infra*.

[11] See pp. 19-20, *supra*.

[12] See Schmuck, *supra*, n. 10, p. 23, at 760-61; see n. 15, p. 25, *infra*.

[13] See Simon, *New Regulations on Insurance Companies Take Doubtful Position*, 14 J. Taxation 114, 116 (1961); *Report of Joint Advisory Committee on Interpretation of Company Federal Income Tax Law*, 1961 Proc. Legal Section, ALC, 330, 332.

affecting the vast majority of life insurance companies.[14] The presence of the unresolved "national" issues, such as the ones involved in this case, has greatly slowed down the "closing" of taxable years for the life insurance companies,[15] and has had the further undesirable effect of leaving substantial numbers of other issues in those years unsettled. Of course, the basic questions as to treatment of deferred premiums will affect future years' returns and audits until resolved.

For the reasons just touched on, it is believed that the issues involved in this case are, if anything, of greater public importance than those involved in *United States* v. *Atlas Life Ins. Co., supra,* where this Court granted certiorari on the only petition for certiorari under the Act presented to it prior to this case. As were the issues in *Atlas,* the issues respecting premiums deferred and uncollected in this case

[14] On October 1, 1963, the American Life Convention and the Life Insurance Association of America submitted eight major issues, which had been raised generally on the initial audits under the Act, to the national office of the IRS. See Schmuck, *supra,* n. 10, p. 23, at 759. Among them were the issues as to premiums deferred and uncollected. These issues, "for some companies, involve potential tax deficiencies exceeding substantially the amount involved in all other issues arising under the 1959 Act." *Id.,* at 771.

[15] Thus, after the submission of the ALC-LIA presentation referred to in the preceding footnote, the national office of the IRS sought to formulate a position by requiring agents to submit issues for "technical advice." "In the meantime, [i.e., in March 1964] it directed that tax audits of life insurance companies be held in abeyance—audits in many cases raising issues involving millions of dollars for a single company and creating great uncertainty about the correct figures to be used as the starting point for tax returns for subsequent years." Schmuck, *supra,* n. 10, p. 23, at 760. Because resolution of the issues was slow, "most life insurance companies have given successive waivers of the statute of limitations, keeping open their tax returns since 1958." *Ibid.* Indeed, the "freeze" on audits was not lifted until May 10, 1967. Johnson, *1967 Report on Federal Legislation and Regulation,* 1967 Proc. Legal Section, ALC, 252, 260.

are of relevance to virtually all taxable years for virtually all life insurance companies. Like the issues in *Atlas*, these issues are among the relatively few basic "national" issues arising under the Act. The Court in *Atlas* granted certiorari on the representation by the government that the decision below involved approximately $400,000,000 in taxes for prior, open years.[16] The figures which we have indicated above lead to the inference that amounts of at least this order of magnitude would be involved in the instant case for all the open years for the industry as a whole. Petitioner's size is only about one-half of one percent of the industry as a whole.[17] For only five taxable years, the amount at stake for petitioner was, as calculated in the District Court, with respect to the issues as to deferred and uncollected premiums, $873,740.—As indicated above, the "asset" aspect of the "premiums deferred and uncollected" questions is common to all life insurance companies and the "income" aspects are believed to be primarily applicable at least to the stock companies. The potential tax deficiencies involved are thus enormous.

(*d*) In *Atlas*, the petition also stressed the volume of litigation threatened by the decision. An estimate of 8,000 claims for various past years was made.[18] The issues involved here are at least as broadly applicable to life insurance companies as the issues in *Atlas*. An increasing number of "open" years since the effectiveness of the Act have ensued with the passage of time for the companies—many now have ten "open" years. Thus, it is believed that

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[16] Petition for Certiorari, p. 16.

[17] The assets of United States life insurance companies as a whole were approximately $177,400,000,000 as of December 31, 1967. *Life Insurance Fact Book* (1968), *supra*, p. 63. Petitioner's assets accounted for only $1,024,000,000 of this.

[18] Petition for Certiorari, p. 17.

an even greater number of deficiency assessments against the 1,700 life insurance companies in the United States is implicit in the issues involved here than the 8,000 claims cited in *Atlas*.

The process of auditing life insurance company tax returns has been a slow one—interrupted by a suspension of audits for several years while the IRS' position on certain national issues was resolved at the national administrative level.[19] Yet there is a substantial body of litigation on these issues already pending in court. The cases pending are set forth in the margin.[20] Moreover, the re-

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[19] See the discussion at n. 15, p. 25, *supra*.

[20] The following are the twenty-four cases other than this one known to be pending:

Alaska Western Life Ins. Co., Tax Court, No. 3135-68;
Allstate Life Ins. Co., Tax Court, Nos. 1622-66 and 5414-67;
American Fidelity Life Ins. Co., Tax Court, No. 4469-63;
Atlantic and Pacific Life Ins. Co., Tax Court, No. 2682-67;
Bankers National Life Ins. Co., Tax Court, No. 655-68;
Columbus Mutual Life Ins. Co., Tax Court, No. 1540-68;
Equitable Life Ins. Co. of Iowa, Tax Court, No. 4701-68;
Eureka Life Ins. Co., Tax Court, No. 4513-68;
Farmers & Bankers Life Ins. Co. v. *United States*, D. Kan., No. W-3977;
Globe Life Ins. Co. v. *United States*, N.D. Ill., Civil No. 67-C-1991;
Great National Life Ins. Co. v. *Campbell*, N.D. Tex., C. A. No. 3-441;
Heart of America Life Ins. Co., Tax Court, Nos. 3937-64 and 2458-67;
Jefferson Standard Life Ins. Co. v. *United States*, 272 F. Supp. 97 (M.D.N.C. 1967), *appeals pending*, 4th Cir., Nos. 12,326 to 12,328;
Kentucky Central Life Ins. Co., Tax Court, No. 5290-67;
Lamar Life Ins. Co. v. *United States*, S.D. Miss. Civ. Nos. 4247 and 4248;
National Farmers Union Life Ins. Co. v. *United States*, D. Colo., Civ. No. 9415;
National Life and Accident Ins. Co. v. *United States*, M.D. Tenn., Civ. No. 4995;
Occidental Life Ins. Co. of California v. *United States*, C.D. Cal., Civ. No. 66-273-F;

sponse to a questionnaire circulated to the membership of the American Life Convention[21] in connection with the preparation of this Petition indicated, that of the 169 companies responding to the questionnaire, the IRS has already administratively questioned 153 or 91% of the companies' treatment of the loading on deferred and uncollected premiums, and that in 75% of the cases where questions have been raised deficiencies have already been assessed with respect to one or more years. Thus, in the light of the universal nature of this question in the life insurance industry, it may be expected that much more litigation is soon to be generated, and that if this Court authoritatively resolves the issues now, a guide will be furnished for the disposal of all these cases.

These issues have already caused more than seven years of extreme uncertainty—ever since the IRS regulations were promulgated—to the life insurance industry. That uncertainty should not be permitted to continue. The potential for litigation inherent in these issues, the uncertainty which will prevail until their resolution, the large amounts of taxes for many years involved, and the already apparent

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Ohio State Life Ins. Co., Tax Court, No. 5971-67;
Old Line Life Ins. Co. v. *United States*, E.D. Wis., No. 68-C-149;
Old Security Life Ins. Co., Tax Court, Nos. 4239-64 and 394-68;
Security Benefit Life Ins. Co. v. *United States*, D. Kan., No. T-4444;
Washington National Ins. Co., Tax Court, No. 3057-68;
Western Life Ins. Co., Tax Court, Nos. 5202-65 and 6150-65.

[21] The American Life Convention comprises approximately 350 life insurance companies which are, generally speaking, the larger companies in the industry. Both stock and mutual companies are included in the American Life Convention's membership.

large backlog of cases at the judicial and administrative levels, together with the conflict in decisions which has already arisen,[22] all unite to indicate the need for a speedy resolution by a grant of certiorari.

B. *The Issues Respecting Unearned Interest on Policy Loans*

1. *The Questions Are Substantial.*—The Court of Appeals held that inasmuch as petitioner had received the prepaid policy loan interest "under a claim of right" and "without restriction as to its use" it had realized income in the full amount of the interest, even though the interest was only earned day by day thereafter. (p. 12a, *infra*) But this clearly is an overly simplistic view of the law on the subject. For example, a taxpayer borrowing money from a bank pursuant to an antecedent credit agreement receives the money under a claim of right and without restriction as to its use. The proceeds of the loan, however, are not income for the obvious reason that there is a fixed and determinable liability to pay an equivalent amount of money back. And so in this case; petitioner was subject to a liability to refund the unearned interest; the amount of that liability diminished pro rata every day, as the interest was earned; and it is only as that liability diminished that the interest can be said to be income.

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[22] As indicated above, on the "asset" issues involved in the questions with respect to premiums deferred and uncollected, there is already a flat conflict between the decision below and the decision of the Tax Court in *Western National Life Ins. Co.*, 50 T.C., No. 28. See p. 19, *supra*. To the same effect as the holding below is *Jefferson Standard Life Ins. Co.* v. *United States*, 272 F. Supp. 97 (M.D.N.C. 1967), *appeals pending*, 4th Cir., Nos. 12,326 to 12,329.

The court below apparently conceived that it was acting under compulsion of this Court's decisions in *Schlude* v. *Commissioner*, 372 U.S. 128 (1963) and *American Automobile Ass'n* v. *United States*, 367 U.S. 687 (1961). (See pp. 12a-13a, *infra*) But those cases did not involve a countervailing liability, which was only abated pro rata with the passage of time, on the part of the taxpayer to refund the advance amounts. The cases involved the receipt of annual membership fees in advance (*Automobile Ass'n*) or the actual receipt of money for dancing lessons in advance (*Schlude*) where the taxpayers had no liability for the making of a refund whatsoever and where the services to be performed were not to be performed at any specific or ascertainable times, but on demand, within contract limits, at the option of the member or subscriber. See 372 U.S., at 135-36.

The respondent conceded below (Brief, pp. 46, 49) that the taxpayer's measurement of interest income as "unearned" and "earned" was regularly and solidly done and based on solid accounting principles. But the court below treated this fact, and the petitioner's unquestioned liability to refund unearned interest, as irrelevant inasmuch as the petitioner had originally received the sums in question under a "claim of right." But the very point of the decisions in *Schlude* and *Automobile Ass'n* was that the taxpayers there had no liability to make a refund and they could not demonstrate any solid basis for the method in which they treated the prepaid sums as "earned" or "unearned"; there was no relationship between the services rendered by them and the rate at which they treated the moneys as earned.

In contrast, the sums involved here were subject to a precise refund obligation, which scaled downwards from

day to day, and were in respect of a "service"—the loan or forbearance of money—which has historically been measured in value on a daily basis. The case is thus on all fours with the motor vehicle finance cases, *Gunderson Bros. Engineering Corp.*, 42 T.C. 419 (1964), and *Luhring Motor Co.*, 42 T.C. 732 (1964). In these cases a finance charge was added to the cash sales price by the dealers, who sold cars on a deferred payment basis. The taxpayer by law or custom was required to refund the unearned portion of the finance charge—essentially interest—upon prepayment by the buyer. The Tax Court held that the dealers were not required to include the finance charges until earned; indeed, it reached this result by analogizing the finance charge to interest: "[T]he finance charge, being similar in all respects to interest, accrues ratably." 42 T.C., at 429.

The IRS acquiesced, stating that "because of the purchaser's right to abatement, the taxpayer's right to receive the finance charge becomes fixed only through the passage of time without the purchaser making early payments." Rev. Rul. 67-316, 1967-39 Int. Rev. Bull. 7, 8. See also *Smith Motors, Inc.* v. *United States*, 61-2 U.S. Tax Cas. ¶9627 (D. Vt. 1961). This has long been the position taken with respect to advance interest of banks and other financial institutions.[1]

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[1] As to discount, see S.M. 3820, IV-2 C.B. 32, 33 (1925) ("Bank discount is the compensation charged by the bank for the use of its money, and hence is earned in the same way as interest—by lapse of time. . . ."). Actually prepaid interest appears to be accounted for by banks and other financial institutions in the same way, without apparent administrative challenge. See Banking Law Journal, *Federal Income Taxation of Banks and Other Financial Institutions* (1968), ¶5.03(a). As to discounted advance interest, see also Mertens, *Law of Federal Income Taxation* (1967), § 12.28; Prentice-Hall, *Federal Taxes* (1966), ¶7215. The Revenue Ruling as to prepaid interest on which the

Paradoxically, another panel of the court below has recently held that advance receipts are not income until earned, even where there was not any obligation to make a refund and the only factor present was the fact that the related services had to be performed at specific times. *Artnell Co.* v. *Commissioner,* 7th Cir., September 19, 1968, 68-2 U.S. Tax Cas. ¶ 9593.[2] This is in the sharpest possible conflict with the approach of the panel below which treated receipt under a claim of right as the sole determinative factor.

In the *Artnell* case, because of a corporate reorganization, the taxable year of the company operating the Chicago White Sox terminated on May 31. Prior to that date, the club had sold season tickets and single admissions, and had received revenues for broadcasts and telecasts, of games scheduled after May 31. The panel, reversing the Tax Court, held that the amounts which had been received prior to May 31 in respect of games to be played thereafter were not to be included in income in the taxable period ending May 31. It observed: "the uncertainty stressed in those decisions [the *Automobile Ass'n* and *Schlude* cases] is not present here. The deferred income was allocable to games which were to be played on a fixed schedule." 68-2 U.S. Tax Cas., at p. 88,054. Here, too, the policy loan interest was earned by the taxpayer only day by day; and the respondent conceded the propriety of this day-by-day accrual as a matter of accounting.[3]

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assessment against petitioner is based (Rev. Rul. 58-225, 1958-1 C.B. 258) is one rendered specifically in the context of the treatment of life insurance companies.

[2] The Commissioner has filed no petition for rehearing in *Artnell* and thus has made no effort to resolve the intra-circuit conflict.

[3] See p. 30, *supra.*

In holding advance unearned interest taxable, the decision of the court below appears to go further than any decided case[4] in imposing a tax on sums which a taxpayer cannot be said fairly to have earned by the close of the taxable year. Again, of itself, this factor would suggest the need for review by this Court, particularly in view of the apparent misconception below as to the effect of this Court's recent decisions in this area.[5]

2. *The Questions are of Substantial Public Importance.* —The issue as to inclusion in income of the loan interest discounted in advance is, of course, one which transcends the context of the Life Insurance Company Income Tax Act. There is nothing in the rationale of the court's opinion which would limit its holding to that context.[1] None-

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[4] With the exception of *Jefferson Standard Life Ins. Co.* v. *United States*, 272 F. Supp. 97 (M.D.N.C. 1967), *appeals pending*, *supra*, n. 22, p. 29, which deals with the same issue.

[5] For similar reasons, the court's holding that capitalized unearned interest added to the principal of a policy loan is to be included in petitioner's assets for the purposes of the computations of its taxable investment income under §§ 804-06 is erroneous. Section 805(b)(4)(B) provides that in computing assets the amount attributable to the asset shall be its basis for the purpose of determining gain on sale or other disposition; and under § 1012 of the Code, the basis of property is cost. Since petitioner has not paid anything for the capitalized unearned interest nor included anything in it in respect of income (under the view for which we contend), the capitalized unearned interest has no basis and accordingly should not be taken into account as an asset. If the Court of Appeals erred, as we contend, in its conclusion with respect to inclusion of these amounts in income, its conclusion as to their status as an asset should also fall.

[1] Indeed, it would appear that an argument is available under the Life Insurance Company Income Tax Act in favor of petitioner which is not available to taxpayers generally. The Act, at § 818(a), p. 77a, *infra*, expressly forbids life insurance companies to use, or the Commissioner to sanction the use by them, of the "cash receipts and disbursements method" of accounting. On the other hand, § 451(a), p. 78a, *infra*, of the Code which applies to taxpayers generally provides that items of gross income shall be included for

theless, the issue is of substantial importance to life insurance company taxpayers. It is important to note that because the income item in question—interest on policy loans —is an item used in computing "taxable investment income," the issues here are fully applicable to all companies, including those, such as mutual companies, whose taxable investment income may tend to exceed gain from operations.[2] (See pp. 21-22, *supra*)

At year-end 1967, United States life insurance companies had $10,059,000,000 in policy loans outstanding to their policyholders, and these loans constituted 5.7% of the companies' assets.[3] While practices vary, it is believed that a substantial number of the companies issue policies providing that interest on policy loans is to be charged in advance rather than in arrears. The responses of 169 members of the American Life Convention responding to a questionnaire in connection with the preparation of this Petition indicated that 73% had policies outstanding on

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the taxable year in which received by the taxpayer unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period. Petitioner's method of accounting takes the interest into account when earned, rather than received, and hence is more properly an accrual method of accounting than the cash receipts method here contended for by the IRS. Under the Act, the cash receipts method is forbidden, whereas under the Code generally it is the starting point unless another approach is appropriate for recording the time of inclusion. Nonetheless, we would contend that under either provision the items in question here should not be taken into account until earned by an accrual basis taxpayer.

[2] And the court's holding that capitalized unearned interest was to be included in the asset base likewise affects all life insurance companies, inasmuch as the size of the asset base is relevant to the computation of the taxable and nontaxable shares of investment income. See pp. 22-23, *supra*.

[3] Institute of Life Insurance, *Life Insurance Fact Book* (1968), p. 86.

which policy loan interest was charged in advance.[4] If one assumes that a similar proportion prevails among the 1,700 companies in the industry, the problem is common to over 1,200 companies. Figures published by the Institute of Life Insurance support the estimate that with respect to the United States life insurance industry as a whole, the effect of the court's ruling, with respect to 1966 alone, is to include $35,800,000 of unearned interest in investment income.[5]

Only the tip of the iceberg of litigation on this issue, too, is visible. Cases involving at least eight other companies are already pending in court.[6] But inquiry has indicated that questions have been raised by the IRS on the administrative level in a substantial number of additional cases. Of the 123 companies responding to the questionnaire circulated by the American Life Convention to its membership in connection with the preparation of this Petition who indicated that they charge policy loan interest in

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[4] See n. 21, p. 28, *supra*.

[5] The published industry-wide figure of $420,000,000 in *earned* policy loan interest (NAIC form, Exhibit 3, line 5, column 7) for 1966 here was the starting point of the estimate. An analysis of the hundred largest companies (in themselves accounting for 90% of the figure) was made to determine the average ratio of *unearned* interest (Exhibit 3, line 5, column 2) on their reports to earned interest. This ratio was then applied to the industry-wide figure.

[6] The following are the cases known to contain this issue:

Bankers National Life Ins. Co., Tax Court, No. 655-68;
Columbus Mutual Life Ins. Co., Tax Court, No. 1540-68;
Eureka Life Ins. Co., Tax Court, No. 4513-68;
Great National Life Ins. Co. v. *Campbell*, N.D. Tex., C. A. No. 3-441;
Jefferson Standard Life Ins. Co. v. *United States*, 4th Cir., Nos. 12,326 to 12,328;
Kentucky Central Life Ins. Co., Tax Court, No. 5290-67;
Old Line Life Ins. Co. v. *United States*, E.D. Wis., No. 68-C-149;
Washington National Ins. Co., Tax Court, No. 3067-68.

advance, 91, or 74%, of the companies indicated that the Internal Revenue Service has questioned their treatment of advance interest. In 69% of the cases in which a question has been raised, a deficiency has already been assessed for one or more years. Because of the fact that so many taxable years for so many life insurance companies are still "open", the effect of this issue even on the years to date will be most substantial in terms of the processing of deficiencies and the dollar amounts involved, even taking the above figures in themselves, let alone extrapolating from them to the industry as a whole. A student of the Act recognizes this as one of the major unresolved questions as to life insurance company income taxation.[7]

Moreover, as indicated above, other financial institutions taking advance payments of interest may also be affected, although, paradoxically enough, it appears to be the case that these other institutions have been administratively permitted not to include unearned interest discounted in advance in income.[8] Thus, either a completely baseless discrimination will have to be made between the treatment of these other institutions, on the one hand, and that of life insurance companies, on the other, or the unsettling effects of the decision below will have to be applied to these other institutions. This factor and the volume of deficiencies and disputed taxes involved, as well as the conflict between the decision of the panel of the court below in this case and in the *Artnell* case, indicate that these questions, as well as the questions involving premiums deferred and uncollected, should be resolved by this Court at this time.

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[7] Schmuck, *supra*, n. 10, p. 23, at 777-79.

[8] See n. 1, p. 31, *supra*.

CONCLUSION

For the reasons stated, this Petition for Certiorari should be granted.

Respectfully submitted,

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APPENDICES

APPENDIX A

Opinion of Court of Appeals

IN THE
UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT
SEPTEMBER TERM, 1967—APRIL SESSION, 1968
No. 16580

THE FRANKLIN LIFE INSURANCE COMPANY,

Plaintiff-Appellee,

—v.—

UNITED STATES OF AMERICA,

Defendant-Appellant.

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF ILLINOIS

July 11, 1968

Before CASTLE, *Chief Judge,* HASTINGS, *Circuit Judge,* and KNOCH, *Senior Circuit Judge.*

CASTLE, *Chief Judge.* The United States of America, defendant-appellant, prosecutes this appeal from a judgment in the amount of $1,303,011.88 entered against it in

favor of The Franklin Life Insurance Company,[1] plaintiff-appellee. The judgment represents a refund of amounts assessed against the taxpayer as income tax deficiencies, and interest thereon, for the calendar years 1958 through 1962. The taxpayer had paid the deficiencies and brought suit in the District Court for refund.

The issues presented on appeal involve the construction and application of the Life Insurance Company Income Tax Act of 1959, Sections 801 through 820 of the Internal Revenue Code of 1954, as amended (26 U.S.C.A., §801-§820). The Act establishes a statutory framework directed to the measurement of life insurance company total income on an annual basis for use in the application of an annual tax. It utilizes a series of separate computations in the determination of the final tax.[2] A tax at corporation rates is levied on "life insurance company annual income". As it applies in the instant case, a third factor having no application to the taxpayer for the years here involved, such annual income is defined in Section 802(b) to be the sum of:

> "(1) the taxable investment income (as defined in section 804) or, if smaller, the gain from operations (as defined in section 809), [plus]
>
> (2) if the gain from operations exceeds the taxable investment income, an amount equal to 50 percent of such excess, ..."

In addition to defining various of the items to be used in the computations required in the ascertainment of in-

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[1] Hereinafter referred to as "taxpayer".

[2] For a short description of the Act, see *United States* v. *Atlas Life Insurance Co.*, 381 U.S. 233.

vestment income and gain from operations, the Act (Section 818(a)) provides:

> "All computations entering into the determination of the taxes imposed by this part shall be made—
>
> (1) under an accrual method of accounting, or
>
> (2) to the extent permitted under regulations prescribed by the Secretary or his delegate, under a combination of an accrual method of accounting with any other method permitted by this chapter (other than the cash receipts and disbursements method).
>
> Except as provided in the preceding sentence, all such computations shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners."

The first two specific issues presented on appeal involve basically the same problem—that is, the way in which deferred and uncollected portions of gross annual premiums[3] are to be handled in the computations. The Com-

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[3] The gross annual premium under a life insurance policy is the consideration paid by the insured for coverage for a policy year, which is twelve-months from the date of issuance of the policy, and each twelve-month period subsequent to its anniversary date. Deferred and uncollected premiums are portions of the annual premiums on policies in force at the end of the taxable year on which collection has not been made. This non-collection is attributable either to the fact that (1) policy premium installments are spread over the policy year and a portion of the gross annual premium will not be collected until the following taxable year, or (2) the premium is due but not yet paid because of the thirty-one day grace period provided in the policies.

In addition, the gross annual premium (and any deferred or uncollected portion thereof) is composed of two elements. The net valuation portion, referred to as the net valuation premium, is an

missioner held: (1) that taxpayer in computing gain from operations pursuant to Section 809 was not entitled to a deduction or offset for "increase in loading on deferred and uncollected premiums" and (2) that taxpayer was not entitled to exclude the loading on deferred and uncollected premiums from assets in the computation of investment income pursuant to Section 804, but was required to reflect the full gross premium in assets. The District Court concluded, to the contrary, that taxpayer was entitled to deduct or offset the item "increase in loading on deferred and uncollected premiums" in computing gain from operations, and was entitled to exclude the loading on deferred and uncollected premiums from assets for purposes of the Section 804 computation of investment income.

The other two specific issues involve the treatment of interest on loans to policyholders. The life insurance policies and annuity contracts issued by taxpayer, which have cash values, provide that a loan may be obtained on the sole security of the policy at any time that a cash value is available and while the policy is in force. Interest on policy loans is payable in advance at the time the loan is made to the end of the current policy year and annually thereafter on the policy anniversary date for the ensuing year. If interest on the policy loan is not paid when due, it is added to the principal of the existing loan and bears interest at the same rate. The Commissioner held that the full amount of the interest paid in

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amount, computed under legally required interest and mortality assumptions, which it is estimated will be required each policy year for reserves for payment of policy claims. The difference between gross annual premium and net valuation premium, referred to as loading, makes up the second portion. It represents agents' commissions, administrative expenses, etc.

advance must be included in investment income in the year of its receipt, and that the full amount of interest added to principal must be included in assets in the investment income computation in the year added. The District Court concluded that taxpayer need recognize as income only the portion of the interest received and deemed earned in the taxable year, and need recognize for asset purposes only the portion of interest added to principal deemed earned in the taxable year.

Examination of the District Court's findings and conclusions reveals that it rejected the Commissioner's holdings with respect to the treatment to be accorded to loading on deferred and uncollected premiums on the premise that the treatment of this item in the annual statements filed by taxpayer with the various state insurance departments reflects a method of accounting with respect to such item which must be given governing effect in the computation of the "gain from operations" and "investment income" factors of the tax formula contained in the Internal Revenue Code. In this connection the record discloses that the treatment accorded the loading on deferred and uncollected premiums under the method of accounting prescribed by the National Association of Insurance Commissioners (NAIC) for use in the preparation of the annual statement form it has designed to show the solvency status on a liquidation basis of life insurance companies permits the offsetting of increase in loading on deferred and uncollected premiums in the determination of company income and the exclusion of loading on deferred and uncollected premiums in the determination of company assets. The NAIC was organized in 1871 and is a national organization composed of the officials of the various states who are charged

with the supervision of life insurance companies and their operations. Soon after its organization, the NAIC adopted a uniform annual statement form and life insurance companies have filed their annual statements since that time on such forms in accordance with the instructions prepared by the NAIC for such purpose. The taxpayer was required by the laws of Illinois, the state of its incorporation, and of the other states in which it did business to complete and file the NAIC annual statement form and to comply with the instructions approved by the NAIC for use in that connection. The taxpayer did so with respect to its annual statements for the tax years here involved.

But it is our opinion that the District Court erred in giving overriding effect to the method of accounting utilized by the NAIC for annual statement purposes. Reliance upon the provisions of Section 818(a) quoted supra does not warrant the conclusion the court reached. The crucial question here is not whether the method of accounting prescribed by the NAIC in connection with the annual statement form it has designed to show solvency status is in its nature a form of accrual accounting or whether the adjustments permitted thereunder are required or appropriate for the purpose the annual statement form is to serve. Nor is it of import that Section 818(a) in prescribing that "computations" entering into the determination of the tax imposed shall be made under an accrual method of accounting provides that except for such restriction[4] computations shall be made in a

[4] The clause of Section 818(a) which permits use of a combination of accounting methods exclusive of a cash receipts and disbursements method, to the extent permitted by regulation prescribed by the Secretary or his delegate, has no application in the instant case.

manner consistent with that required for NAIC annual report purposes. The careful and detailed attention given by Congress throughout Sections 801 through 820 to definition of the particular items utilized as factors in the tax formula and in specifying and enumerating the permissible deductions and exclusions negates the existence of any intent on the part of Congress to relegate the substantive matter of offsetting or excluding loading on deferred and uncollected premiums, with its concomitant impact on the resulting tax, to the NAIC.

Section 809(c)(1) specifically requires the inclusion of "the gross amount of premiums" for the purpose of determining "gain from operations" as defined in Section 809(b)(1). Taxpayer concedes that the intent and purpose of the Act require that the deferred and uncollected premiums be included in income on a gross basis (which includes loading). In our view that concession leaves no basis for further controversy. This is especially so in view of the fact that Congress has provided twelve specific deductions in Section 809 but makes no provision for an offset or deduction for "increase in loading". And, the burden is on the taxpayer to show the express statutory authority for a deduction claimed. *Equitable Life Insurance Co. of Iowa* v. *United States,* 8 Cir., 340 F. 2d 9.

Taxpayer seeks to justify the District Court's exclusion of loading on deferred and uncollected premiums from assets in the computation of "investment income" pursuant to Section 804 on the basis of taxpayer's obligations to policyholders, *i.e.,* reserves. But taxpayer in computing its reserves for tax purposes did so on the assumption that on each policy anniversary the full annual premium has been received. The very reason for showing deferred and uncollected premiums in full in assets is that this is

in accord with actual accrual accounting principles. Wightman, Life Insurance Statements and Accounts (1952), pp. 44-46. The assumption that the annual premium has been received in full is, of course, a fiction, since annual premiums on all policies have not been received as of the end of the taxable year; rather, a portion thereof remains deferred and uncollected. The use of the fiction results in a bigger reserve liability figure and consequently bigger reserve liability deductions and exclusions than if reserves were computed on the basis of only those premiums actually received. If the fictional assumption were not indulged and only those reserves were accrued as were attributable to paid up portions of annual premiums, then the problem from an accrual standpoint would be simpler. But, Congress, apparently cognizant of the assumption upon which taxpayer and other life insurance companies compute reserves for annual statement purposes because of state statutory requirements chose to recognize such assumption in the tax formula it prescribed and to base an accrual reporting requirement on that assumption. And, the application of accrual principles after that assumption has been made, will not permit of accrual of the entire annual reserve on one hand without incident accrual of the full annual premium. The District Court would permit the taxpayer to accrue a full year's liability without a corresponding accrual of the related year's asset in point of time. Such a result would attribute to Congress an intention that in the same statutory equations, exclusions and deductions attributable to reserves are to be based on the assumption that the annual premium is fully paid up and yet the amounts in the same equation from which these figures

are to be subtracted are to be determined on the assumption that the annual premium is not fully paid up. This is, in effect, saying that Congress, when it specified accrual accounting, must have meant one rule to apply to reserve deductions and exclusions and another different accrual rule to apply to determining the amount from which the former are to be subtracted. We perceive nothing from which intent to impose such a dual standard of tax accounting can be presumed.

That the NAIC is willing to allow an admittedly overstated reserve while at the same time allowing an accounting entry with respect to assets which, while compensating *numerically* for the overstatement, does not fully account for the related asset, is of no aid to the taxpayer here. The acceptance of such an adjustment as being in accord with conservative and stringent solvency requirements does not permit of the utilization of such an approach to alter or modify the substantive provisions of a tax formula concerned with the *proportionate* relationship between assets and reserves. The gearing of the tax statute to an annual reserve requires recognition of no less than the annual premium.

We conclude on the phases of the appeal concerning the District Court's resolution of the issues involving the treatment of deferred and uncollected portions of gross annual premiums that the District Court erred,[8] and

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[8] We are cognizant of, and have considered, the recent decision of the Tax Court in *Western National Life Insurance Company of Texas* v. *Commissioner* (Opinion dated May 13, 1968) in which it is held that the entire amount of deferred and uncollected premiums is to be excluded from the asset side of the formula. The Tax Court opines that "only resort to medieval metaphysics could translate the items in question [deferred and uncollected premiums] into 'assets' ". But see: *Jefferson Standard Life Insurance Co.* v. *United States*, M.D. No.Car., 272 F. Supp. 97 (1967).

we turn to consideration of the remaining issues related to the treatment of interest on loans to policyholders.

Under the express terms of taxpayer's policy loan agreements with borrowers interest is paid in advance at the time of the loan to the end of the current policy year and annually thereafter on the policy anniversary date for the ensuing year, and interest not paid when so due is added to the principal of the existing loan. As hereinbefore stated, the Commissioner held that the full amount of the interest paid in advance must be included in investment income in the year of its receipt, and that the full amount of interest added to principal must be included in assets in the investment income computation in the year added. The District Court concluded that taxpayer need recognize as income only the portion of the interest received and deemed earned in the taxable year, and need recognize for asset purposes only the portion of interest added to principal deemed earned in the taxable year. In this connection the record discloses, and the court found, that the whole or any part of the indebtedness arising from a policy loan may be repaid at any time; if repayment of a policy loan is made during the policy year, the exact amount of interest ratably earned by the taxpayer is retained by it and the residue is returned to the policyholder; if the policyholder should surrender his policy for the cash value then only the exact amount of prepaid interest ratably earned is retained by the taxpayer and the residue is returned to the policyholder; and if the policyholder should die then only the exact amount of prepaid interest ratably earned is retained by the taxpayer and the residue is paid to the beneficiary of the policy. Capitalized interest

added to principal is similarly retained or returned on the basis of whether it has been ratably earned. Taxpayer's books are kept on this basis. Interest on policy loans is taken into income or assets only as ratably earned. In view of the foregoing considerations the District Court reasoned that the Commissioner's treatment of the prepaid interest and the capitalized interest items constituted application of "a hybrid method of accounting . . . partially on an accrual method and partially upon a cash receipts and disbursements method in contravention of Sec. 818(a)(2) of the Internal Revenue Code of 1954 which enjoins the Commissioner from using the cash receipts and disbursements method for determining the taxable income of a life insurance company".

In support of the District Court's conclusion that taxpayer need recognize as income and assets only the portion of prepaid or capitalized interest which has been ratably earned during the taxable year the taxpayer points to the possibility that if the borrower elects to terminate the loan or dies taxpayer will be in the position of returning some of the interest paid to it, and argues that the money it receives must be *earned* before it is includable in its taxable income as an accrual basis taxpayer.

There is no question that taxpayer is an accrual basis taxpayer. Section 818(a) requires that it utilize an accrual method of accounting for the determination of its income tax. But, non-deferral of prepaid items is not foreign to permissible or required accrual accounting for income tax purposes. *Schlude* v. *Commissioner*, 372 U.S. 128; *American Automobile Association* v. *United States*, 367 U.S. 687, 695. Thus, as pointed out in *North American Oil* v. *Burnet*, 286 U.S. 417, 424:

> "If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent."

And, here the taxpayer receives the interest under a binding agreement with the borrower calling for its receipt and without restriction upon its use by the taxpayer. The money is "earned" in a context sufficient for full tax recognition in that taxpayer, when it receives the interest, is fully entitled to it under the express terms of the policy loan agreement. And taxpayer is free to use or invest the full sum in any way it sees fit. The taxpayer, for the purpose of its own bookkeeping, may choose to reflect the money so received only over the course of the policy year, but this does not negate the fact that the interest has been received without restriction as to its use.

Apart from any charismatic application of the "claim of right" concept referred to in *North American Oil, supra,* we are of the view that the underlying rationale of *Schlude* and *American Automobile Association* leaves the Commissioner free to reject the deferral of prepaid items where not to do so would not "clearly reflect income" in accord with the command of Section 446(b)* of

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*26 U.S.C.A. §446, which provides in pertinent part as follows:

"(a) General rule.—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) Exceptions.—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income."

the Internal Revenue Code. Required use of an accrual method of accounting is not a dispensation from the fundamental precept that the accounting clearly reflect that which by a present right to receipt is "earned", and is subject to the taxpayer's dominion and use, although a possibility of its future return may exist. A recent application of this doctrine is found in *Van Wagoner* v. *United States*, 5 Cir., 368 F. 2d 95. Moreover, taxpayer made no showing of its experience with respect to the return of prepaid interest. It did not demonstrate that any significant amount was actually refunded. In this respect the taxpayer's proposed treatment of the item, with which the District Court agreed, appears to be as artificial as the bases for deferral relied upon and rejected in *Schlude* and *American Automobile Association*.

Taxpayer's reliance upon *Gunderson Bros. Engineering Corp.* v. *Commissioner*, 42 T.C. 419, and *Luhring Motor Co.* v. *Commissioner*, 42 T.C. 732, is misplaced. Those cases did not involve amounts actually received by the taxpayers by way of prepayment. *Beacon Publishing Co.* v. *Commissioner*, 10 Cir., 218 F. 2d 697, and *Schuessler* v. *Commissioner*, 5 Cir., 230 F. 2d 722, are distinguishable. See *American Automobile Association*, 367 U.S. 687, 691, footnote 4. Likewise, certiorari was granted in *American Automobile Association* in recognition of the conflict between *Bressner Radio, Inc.* v. *Commissioner*, 2 Cir., 267 F. 2d 520, and *American Automobile Association* v. *United States*, 149 Ct. Cl. 324, 181 F. Supp. 255, and the conflict was resolved against *Bressner*. Consequently, we are not persuaded by the decisions upon which taxpayer chiefly relies. Nor are we impressed by the support taxpayer attempts to glean from the dissent in *American Automobile Association*.

We conclude that the District Court's conclusion with respect to prepaid and capitalized policy loan interest was erroneous.

We have considered certain additional but subsidiary or peripheral contentions the taxpayer and amicus curiae have advanced in support of their position on appeal, but we are of the view that none of them merit an extension of this opinion for the purpose of discussing the same.

The judgment order of the District Court is reversed.

REVERSED.

APPENDIX B

Judgment of the Court of Appeals

UNITED STATES COURT OF APPEALS

FOR THE SEVENTH CIRCUIT

Chicago, Illinois 60604

Thursday, July 11, 1968

Before

Hon. LATHAM CASTLE, *Chief Judge,*
Hon. JOHN S. HASTINGS, *Circuit Judge,*
Hon. WIN G. KNOCH, *Senior Circuit Judge.*

THE FRANKLIN LIFE INSURANCE COMPANY,

Plaintiff-Appellee,

No. 16580 vs.

UNITED STATES OF AMERICA,

Defendant-Appellant.

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF ILLINOIS

This cause came on to be heard on the transcript of the record from the United States District Court for the Southern District of Illinois, and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the judgment order of the said District Court in this cause appealed from be, and the same is hereby, REVERSED, in accordance with the opinion of this Court filed this day.

APPENDIX C

Order on Petition for Rehearing

UNITED STATES COURT OF APPEALS

FOR THE SEVENTH CIRCUIT

Chicago, Illinois 60604

August 30, 1968

Before

Hon. LATHAM CASTLE, *Chief Judge,*
Hon. JOHN S. HASTINGS, *Circuit Judge,*
Hon. WIN G. KNOCH, *Senior Circuit Judge.*

THE FRANKLIN LIFE INSURANCE COMPANY,

Plaintiff-Appellee,

No. 16580 vs.

UNITED STATES OF AMERICA,

Defendant-Appellant.

On consideration of the petition for rehearing filed herein by The Franklin Life Insurance Company, plaintiff-appellee, and of the answer of the United States of America, defendant-appellant, to said petition:

IT IS ORDERED that the petition for rehearing is denied, and that the concluding portion (last two lines) of the opin-

ion filed and issued herein on July 11, 1968 be modified to read as follows:

> "The judgment order of the District Court is reversed and the cause is remanded to the District Court with directions to enter a judgment order consistent with this opinion.
>
> REVERSED AND REMANDED WITH DIRECTIONS."

AND IT IS FURTHER ORDERED that a judgment order of this Court be entered accordingly.

APPENDIX D

District Court Findings of Fact and Conclusions of Law

FINDINGS OF FACT

and

CONCLUSIONS OF LAW

The Court finds that certain basic information has been stipulated in a Basic Stipulation of Facts, (hereinafter referred to in the Court's findings as "Basic Stip."), filed herein on September 20, 1965; in a Supplemental Stipulation, (hereinafter referred to in the Court's findings as "Supp. Stip."), filed herein on November 15, 1966; and in a Second Supplemental Stipulation (hereinafter referred to in the Court's findings as "Second Supp. Stip."), filed herein on December 16, 1966. The abbreviations "T" and "Tr." refer to the transcript of oral testimony and proceedings at the trial, "JX" and "Joint Ex." refer to joint exhibits, "TX" and "Pltf. Ex." refer to Plaintiff's Exhibits, "DX" and "Deft. Ex." refer to Defendant's Exhibits, and "N.A.I.C." refers to the National Association of Insurance Commissioners.

The Court, in drafting its Findings of Fact and Conclusions of Law, has, because of the numerous and involved issues herein involved, proceeded in the same order and manner as did the trial of the action: with Preliminary Findings of Fact on the stipulated preliminary matter immediately followed by Preliminary Conclusion of Law, as well as Findings of Fact and Conclusions of Law

being separately stated with respect to each of the issues in the case.

(Tr. 198)

PRELIMINARY FINDINGS OF FACT

1. The plaintiff, The Franklin Life Insurance Company, is a life insurance corporation organized and existing under the laws of the State of Illinois with its Home Office and principal place of business in the City of Springfield, County of Sangamon and State of Illinois within the jurisdiction of this Court.

2. The plaintiff was, during the tax years here involved, engaged in the business of a life insurance company as defined in Sec. 801(a) of the Internal Revenue Code of 1954, which, as amended, is hereinafter referred to as "Code."

3. The taxable years at issue in this case are the taxpayer's calendar years 1958, 1959, 1960, 1961, and 1962, inclusive. In addition, although the year 1957 is not at issue, certain adjustments with respect to the year 1957 which were made by the Internal Revenue Service are pertinent in connection with this case, because those adjustments affect the taxpayer's 1959 tax liabilities, for the reasons outlined in Section 818(e)(3)(A) of the Internal Revenue Code of 1954. (Basic Stip., par. 2).

4. The plaintiff timely filed its United States Life Insurance Company Income Tax Returns, Forms 1120L, for the calendar years 1958 through 1962, inclusive, pursuant in each instance to timely extensions of time for filing; the date on which each return was filed and the total in-

come taxes as computed by the plaintiff on each return which total income taxes have been paid in full by the plaintiff are:

Year	*Date of Filing*	*Total Income Tax as Shown on Return*
1958	September 15, 1959	$2,806,154.45
1959	September 14, 1960	$3,173,654.03
1960	[redacted]	[redacted]
1961	September 14, 1962	$4,921,765.30
1962	June 17, 1963	$5,670,054.55

5. The Internal Revenue Service audited plaintiff's United States Life Insurance Company income tax returns for the calendar years 1958 through 1962, inclusive, and assessed the following tax deficiencies, together with interest thereon:

(Tr. 199)

Year	*Tax Deficiency*	*Interest*	*Total*
1958	$138,402.45	$41,238.24	$179,640.69
1959	$218,626.37	$48,127.42	$266,753.79
1960	$253,963.73	$45,194.94	$299,157.67
1961	$279,123.03	$32,925.05	$312,048.08
1962	$173,418.47	$10,051.14	$183,469.61

6. The amounts of deficiency tax and interest hereinabove set forth were paid by the plaintiff in full to the Internal Revenue Service on March 4, 1964, with the exception of a certain portion of the deficiency for 1959 income tax which is payable in ten equal installments in the amount of $2,179.64 each, and so made payable under the provisions of Sec. 818(e)(3)(A) of the Code; the first four

of the said payments of $2,179.64 each were paid in the payment made on March 4, 1964, with the remaining installments falling due in the tax years subsequent to those involved in this action.

7. The plaintiff timely filed, in accordance with the provisions of Sec. 6511 of the Code, the following twelve claims for refund with the Commissioner of Internal Revenue on Internal Revenue Form 843 with respect to the years 1958 through 1962, inclusive:

Year	*Date Claim Filed*	*Amount of Claim*
1958	July 29, 1964	$278,348.76
	August 3, 1964	2,069.12
	December 21, 1964	4,493.34
1959	July 29, 1964	439,998.46
	August 3, 1964	2,069.12
1960	June 11, 1964	236,766.40
	July 29, 1964	184,932.00
	August 3, 1964	2,069.12
1961	July 29, 1964	428,868.59
	August 3, 1964	2,069.12
1962	July 29, 1964	362,266.98
	August 3, 1964	2,069.12

(Tr. 200)

8. This action was timely commenced on February 8, 1965, within the period of limitations prescribed by Sec. 6532(a)(1) of the Code with the exception that the action, when filed, was premature with respect to the claim of the plaintiff filed with the Commissioner of Internal Revenue on December 21, 1964 for the sum of $4,493.34, which pre-

matureness is of no importance to this action as the parties have agreed to the disposition of this claim and have stipulated that its prematureness shall not constitute a bar to the disposition of the claim in accordance with the stipulation of the parties.

9. The Internal Revenue Service assessed interest in the amount of $41,238.24 on the tax deficiency assessed against the plaintiff for the year 1958 which is [illegible] ment erroneously covered a period of time prior to September 15, 1959 and thereby resulted in an overpayment of interest by the plaintiff in the sum of $4,152.07 (Para. 8 of Basic Stip.).

10. The plaintiff's claim for refund dated August 3, 1964, with respect to the calendar year 1958 (Joint Ex. 11), does not relate to any tax paid by the plaintiff with respect to the calendar year 1958. Accordingly, the plaintiff's claim for refund dated August 3, 1964, with respect to the calendar year 1958 was withdrawn, and no refund of tax or interest shall be made with respect to such claim for refund. (Basic Stip., par. 9).

11. In view of the Supreme Court's May 17, 1965 decision in *United States* v. *Atlas Life Insurance Co.*, 381 U.S. 233, the parties stipulated and agreed that, in computing the net taxable income of the taxpayer in this action, the congressionally prescribed formula—which is contained in Sections 804(a)(2) and 809(b)(1) of the Internal Revenue Code of 1954, as enacted by Section 2 of the Life Insurance Company Income Tax Act of 1959, supra, and which has the effect (1) of apportioning investment income from state

and municipal bonds pro rata between the untaxed policyholders' share of such income and the company's share, and (2) of limiting the tax deduction allowed under Section 103 of the Internal Revenue Code of 1954 to the pro rata portion of non-taxable state and municipal bond income allocated to the company's share of investment income—did not result in a tax on state or municipal bonds, or on income derived therefrom. The parties further stipulated and agreed that use of the congressionally prescribed formula described in the previous sentence does not entitle the taxpayer to make the adjustments described in Sections 804(a)(6) and 809(b)(4) of the Internal Revenue Code of 1954, as enacted by the Life Insurance Company Income

(Tr. 201)

Tax Act of 1959. The purpose of this paragraph of these findings is to dispose of the so-called "Atlas Issue" in this case in accordance with the Supreme Court's decision in *United States* v. *Atlas Life Insurance Co., supra.* Accordingly, the claims made in the following paragraphs of the Complaint in this action with respect to the Atlas case were withdrawn: Paragraph 4 of Count I, Paragraph 4 of Count II, Paragraph 4 of Count IV, Paragraph 4 of Count VII, and Paragraph 4 of Count IX. (Basic Stip., par. 10).

12. Unamortized premiums on mortgages are included by the plaintiff in its statement of assets as reflected in the total amount of its mortgages appearing on Line 3 of Page 2 of the Plaintiff's Annual Statements (JX 23 through 27). On Line 3.1 of Page 14 of said Annual Statements of the plaintiff is a statement of the mortgages and loans of the plaintiff and the unamortized portion of the premiums

on the mortgages is shown in Column 2 thereof as a non-ledger asset; the Internal Revenue Service, in making its deficiency assessments against the plaintiff for the year 1959 through 1962, inclusively, mistakenly included the amount of unamortized premiums as it appears on Page 14 of the Annual Statement for each of said taxable years with the result of a double inclusion of the unamortized premiums on mortgages in the statement of assets of the plaintiff which [redacted] amounts indicated below:

Year	*Amount*
1959	$ 42,387.60
1960	179,209.65
1961	267,228.03
1962	262,692.03

As a result of the double inclusion of the unamortized premiums on mortgages in the statement of assets of the plaintiff, a portion of the deficiency assessment, together with interest thereof, for the years 1959 through 1962 which was paid by the plaintiff on March 4, 1964, constitutes an overpayment by the plaintiff which it is entitled to recover (Para. 6 of Supp. Stip.)

(Tr. 202)

13. That plaintiff's experience with disposition of resisted claims reflects that it pays an average of 35.46% of the amount of resisted claims at the end of each year and the parties hereto have agreed by the Second Supplemental Stipulation filed herein that for the years 1958 through 1962 the plaintiff is entitled to a deduction in the amount of 35% of the increase in resisted claims over the

prior taxable year and that in any of the tax years here involved in which there was a decrease in the amount of resisted claims over the prior taxable year, 35% of the amount of such decrease shall constitute an offset against other deductions of the plaintiff relating to death claims.

14. The parties hereto have agreed by the Second Stipulation of Facts filed herein that the plaintiff is not entitled to a deduction for its investment expenses attributable to its investment income from tax exempt state and municipal bonds and that a reasonable method of determining Plaintiff's investment expenses attributable to income from tax exempt state and municipal bonds is by a ratio based upon the percentage of gross investment income of the plaintiff as it relates to its tax exempt income from state and municipal bonds and applying the ratio to the total investment expenses of the plaintiff.

15. That the agreement of the parties to settle the two issues as hereinabove reflected in Findings of Fact 11 and 12 relates only to the years 1958 through 1962, inclusive, and is not binding upon either party with respect to tax years subsequent to the year 1962.

16. The exact amount of refund due the plaintiff in this action, together with interest according to law, will be ascertained after the filing of the Court's Findings of Fact and Conclusions of Law on the basis of a recomputation by the Internal Revenue Service agreed to by both the plaintiff and the defendant which computation shall be made within a reasonable period of time and in the event the parties are unable to agree on such recomputation, they shall submit their dispute to the Court.

PRELIMINARY CONCLUSIONS OF LAW

1. That both the plaintiff and the defendant are properly before the Court and the Court has jurisdiction of the parties and of the subject matter of this action.

2. That both parties have been correctly designated and there is no misjoinder or nonjoinder of parties.

(Tr. 203) [redacted]

3. That the plaintiff, with respect to its Claim for Refund dated December 21, 1964, in the sum of $4,493.34 has made an overpayment of the sum of $4,152.07 which overpayment, together with interest thereon, will be taken into account in the computation to determine the amount of judgment to be entered herein.

4. That the plaintiff has been improperly assessed by reason of the double inclusion of unamortized premiums on mortgages in its assets for the years 1959 through 1962, inclusively, and the sum of the deficiency assessments, together with interest thereon, made against the plaintiff by the Internal Revenue Service for the years 1959 through 1962, inclusive, which is attributable to the double inclusion of unamortized premiums on mortgages in the assets of the plaintiff constitutes an overpayment of taxes and interest thereon by the plaintiff which overpayment will be taken into account in the computation to determine the amount of judgment to be entered herein.

5. That the plaintiff is entitled to a deduction in the amount of 35% of the amount of increase in resisted claims at the end of each tax year here involved over the next pre-

ceding year, and for the tax years here involved in which there was a decrease in the amount of resisted claims over the prior tax year, 35% of the amount of such decrease shall constitute an offset against other deductions of the plaintiff relating to death claims and accordingly 35% of the amount of increase in resisted claims and 35% of the amount of decrease in resisted claims will be taken into account in the computation to determine the amount of judgment to be entered herein.

6. The plaintiff is not entitled to a deduction for its investment expenses attributable to its investment income from tax exempt state and municipal bonds and the amount of plaintiff's investment expenses attributable to income from tax exempt state and municipal bonds will be taken into account in the computation to determine the amount of judgment to be entered herein.

(Tr. 204)

THE PLAINTIFF'S METHOD OF ACCOUNTING IN PREPARING ITS INCOME TAX RETURNS FOR THE YEARS 1958 THROUGH 1962, INCLUSIVE

Findings of Fact

1. The National Association of Insurance Commissioners, hereinafter referred to as N.A.I.C., was organized in 1871 and is a national organization composed of officials of the various states who are charged with supervision of insurance companies and their operations; soon after its organization, the N.A.I.C. adopted a uniform annual statement form and life insurance companies have filed annual statements since that time on forms adopted by the N.A.I.C.;

instructions for the preparation of annual statement forms are also prepared and approved by the N.A.I.C.

2. The Director of Insurance of the State of Illinois furnished the plaintiff forms for the Annual Statements for the tax years here involved, together with instructions for the preparation of said forms.

3. The plaintiff prepared and filed its Annual Statements for the years 1958 through 1962 (JX 25 through 27, inclusive) with the Director of Insurance of the State of Illinois and with the insurance departments of each other state in the United States with the exception of the State of New York in which state the plaintiff does not conduct its life insurance business.

4. None of the states which received the Annual Statements of the plaintiff for the tax years here involved found fault with the plaintiff's method of accounting in the preparation of its Annual Statements.

5. The plaintiff was examined for the years 1958 through 1962 by teams of N.A.I.C. examiners from various insurance departments which examinations were extensive with respect to the financial condition of the plaintiff as the principal purpose of each examination was to determine the financial condition of the plaintiff and the accuracy of the plaintiff's Annual Statements for the years covered in said examinations; the examinations of the plaintiff for the tax years here involved reflected that plaintiff's Annual Statements were completed in the manner required for the purposes of annual statements approved by the N.A.I.C.

(Tr. 205)

6. The Annual Statements of the plaintiff for the tax years here involved, were prepared under the accrual method of accounting for purposes of annual statements approved by the N.A.I.C. in accordance with instructions of the N.A.I.C. furnished to the plaintiff prior to completion of said Annual Statements.

7. The plaintiff's method of accounting as reflected in its Annual Statements is the method of accounting regularly employed by the plaintiff in keeping its books and records which method of accounting is in accordance with the general accepted accounting principles applicable to the life insurance industry.

Conclusions of Law

1. That all computations used by the plaintiff in determining its income taxes for the years 1958 through 1962 were made under an accrual method of accounting in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.

2. That the income tax returns filed by the plaintiff for the tax years here involved were computed under the method of accounting on the basis of which the taxpayer regularly computes its income in keeping its books.

3. That the plaintiff's method of accounting in completion of its income tax returns for the tax years here involved is in compliance with Sections 818(a) and 446(a) of the Code.

I.

INCREASE IN LOADING ON DEFERRED AND UNCOLLECTED PREMIUMS AS INCOME

Findings of Fact

1. The plaintiff is a legal reserve life insurance company and under the state laws governing the plaintiff, reserves for life insurance policies are determined on the basis of the net annual valuation premium regardless of whether an insured pays premiums on an annual, semiannual, quarterly or monthly basis. (T. 83). Certain terms common to the life insurance industry have the following meanings:

(a) *Gross Annual Premium.* This is a consideration paid by the insured to the Company for coverage for a policy year which is twelve months from date of the issuance of the policy and each twelve-months period subsequent to its anniversary date. (T. 84).

(b) *Net Annual Valuation Premium.* This is the amount needed each policy year to pay all policy contract claims according to the mortality tables and assumed rates of interest used in determining the reserve required by Law. (T. 84).

(Tr. 206)

(c) *Loading on the Annual Gross Premium.* This is the difference between the gross annual premium and the net annual valuation premium. (T. 84).

(d) *Deferred and Uncollected Premiums.* These are reserve offsets and are equal to that portion of the annual

premium for the current policy year which has not been received by the Company in the current taxable year. (T. 85).

2. A deferred premium represents only that portion of the annual premium which has not been received in the current policy year and is not that portion of the premiums for the balance of the current policy year which the plaintiff hopes to collect from its policyholders.

3. The total amount of premiums for a policy payable on other than the annual basis exceeds the annual premium for such policy which may be illustrated by assuming that the annual premium for a policy issued on November 28 is $400 and the premium is to be payable on a quarterly basis. Each quarterly premium would be $105 and the aggregate of the four quarterly premiums would be $420 for the policy year. It may be further assumed that the annual net valuation premium for the policy is $360 and the remaining $40 of the gross annual premium would be loading. Under this illustration, one quarterly premium in the sum of $105 is paid on November 28 and at the end of the plaintiff's taxable year the gross deferred premium on this policy is 75% of the annual premium in the sum of $300 and not the sum of the quarterly premiums falling due in the subsequent taxable year in the sum of $315. Under this illustration, the net deferred premium is $270 and the loading on the deferred premium is $30. (T. 94-96).

(Tr. 207)

4. The policies of the plaintiff provide, as required by law, for a 31-day grace period for the payment of premiums when due during which period the policy is carried in full force and effect. If a premium is due in December

of the taxable year but is not paid by the insured during the month of December, the unpaid portion of the annual premium for the policy which was due in December becomes uncollected at the end of the taxable year. This may be illustrated by assuming an annual gross premium due on December 15 in the sum of $400 of which $360 is the annual net valuation premium and $40 is loading. At the end of the year, the plaintiff is required by law to set up a net annual valuation reserve of $360 regardless of whether the annual premium in the sum of $400 due on December 15 is paid in December. (T. 91).

5. The plaintiff does not have the legal right to collect premiums when they become due on its policies as premiums which have not actually been paid to the plaintiff are not contractually due from its policyholders. The provision for the payment of premiums does not afford a cause of action to the plaintiff to collect from its policyholder as the payment of premiums is at the sole election of an insured who may decide to keep his policy in force by such payment of premiums as they fall due or elect to abandon or otherwise permit his policy to lapse by non-payment of premiums. (T. 93).

6. The reserve liability of the Plaintiff, as required by law, is determined at the end of the calendar year and this item of reserve is shown on Line 1 of Page 3 of its Annual Statement as a liability. Included in this liability item are the deferred and uncollected net annual valuation premiums for which the plaintiff has not received an offsetting item of income. The method of accounting prescribed by the National Association of Insurance Commissioners provides for the offsetting of the deferred and

uncollected premiums by the inclusion of the deferred and uncollected premiums in the premium income of the plaintiff. Only net deferred and uncollected premiums are needed as offsets for the net annual valuation portion of the premiums included in reserves and the inclusion of the gross deferred and uncollected premiums overstates the premium income of the plaintiff. The Annual Statement required of the plaintiff provides a method of offsetting the overstatement of unreceived income.

7. The following is an illustration of the overstatement of unreceived income and the method of offsetting the amount of overstatement that is not necessary to offset the increase in reserves attributable to deferred and uncollected premiums.

(Tr. 208)

(a) On November 28, 1960, the plaintiff sells a policy on a quarterly basis providing for quarterly premiums of $105 each. The gross annual premium would be $400 and the annual valuation premium would be $360. At year end, the plaintiff must set up in its Annual Statement, a $360 reserve for this policy notwithstanding the fact that it has only received the sum of $105 and only $90 of which is the portion of the net annual valuation premium. This leaves a deferred and uncollected net annual valuation premium in the sum of $270. With respect to the $360 increase in reserves, the plaintiff has received the sum of $90 in cash which is insufficient to offset the reserve liability and the plaintiff must show another $270 item in order to fully offset the reserve for the policy sold in 1960.

(b) The annual report form of the plaintiff requires the inclusion of $300, the gross deferred and uncollected premium, as premium income together with the $105 actually received for the policy.

(c) The plaintiff, through the employment of this method of accounting, has overstated its income by $300 which is $30 more than the required $270 offset for the liability required by law.

(d) The Annual Statement of the plaintiff recognizes that there would remain an overstatement without some provision of an offsetting figure therefor, and next provides for a method of further offsetting the $30 overstatement so that the plaintiff will have only included in its summary of operations the actual premiums received together with the portion necessary to offset the increase in reserve attributable to deferred and uncollected premiums. (T. 94-97).

8. The actual method of offsetting the overstatement of deferred and uncollected premiums is shown by reference to the Annual Statement of the plaintiff for the years 1959 (JX 24) and 1960 (JX 25) and is illustrated as follows:

(a) At the end of 1959, the reserves of the plaintiff were, in round figures, $389,000,000 which is reflected in Line 1 on Page 3 of the Annual Statement. (T. 124).

(b) Of the foregoing amount, the net deferred and uncollected premiums of the plaintiff were, in round figures, $18,200,000 which is reflected on Line 17 of Page 2 of the Annual Statement. (T. 125).

(c) At the end of 1960, the reserves of the plaintiff amounted to $425,000,000 which is reflected on Line 1 of Page 3 of the Annual Statement for 1960. (T. 125).

(d) Of the foregoing sum, $20,000,000 is the net amount of deferred and uncollected premiums and this item appears on Line 17 of Page 2 of the Annual Statement for 1960. (T. 126).

(Tr. 209)

(e) The increase in reserves in the sum of $36,000,000 is reflected on Line 17 of Page 4 of the Annual Statement for 1960. (T. 126).

(f) On Line 1 of Page 4 of the Annual Statement for 1960 appears premium income of $98,000,000 representing premiums received together with gross deferred and uncollected premiums which were not received. (T. 131, 136).

(g) The foregoing $98,000,000 figure is composed of the entries made in Exhibit 1 appearing on Page 7, Column 1 which shows the composition of the $98,000,000 figure. (T. 135).

(h) The reserve figure on Line 17 of Page 4 of the Annual Statement for 1960 in the sum of $36,000,000 represents the increase over the prior year. Of this $36,000,000, $1,800,000 is the increase in reserves attributable to deferred and uncollected premiums which have not been received by the plaintiff in 1960. The gross amount of the deferred and uncollected premiums has increased by $2,165,000 which figure is included in the $98,000,000 figure on Line 1 of Page 4. Thus, the increase in deferred and uncollected

premiums of the plaintiff is overstated by $365,000 ($2,165,000-$1,800,000) which sum is not necessary to offset the increase in reserve and accordingly, Line 25 of Page 4 of the Annual Statement provides for the offsetting of the $365,000 figure. (T. 131-134).

9. That the $365,000 figure in the foregoing example does not constitute taxable income to the plaintiff for the year 1960. (T. 137).

10. Deferred and uncollected premiums are included as accrued income for the sole purpose of offsetting the part of unreceived net premiums required in reserve calculation. The method of accounting prescribed by the National Association of Insurance Commissioners for the plaintiff in providing for an offset for the increase in reserves of the plaintiff provides for the inclusion of the gross deferred and uncollected premiums less the increase in loading thereon with the effect of including in gross income only that portion of the deferred and uncollected premiums necessary to offset the increase in reserves attributable to deferred and uncollected premiums. (T. 137).

(Tr. 210)

11. To include the increase in loading on deferred and uncollected premiums in the income of the plaintiff for any taxable year would constitute an overstatement of the income of the plaintiff by that amount for each of the taxable years and would be an improper inclusion of an item in income which the plaintiff has no right to receive. (T. 258, 544).

12. Under the method of accounting prescribed for the plaintiff by the National Association of Insurance Commissioners, the plaintiff has, in each of the taxable years here involved, included in its premium income only the amount of the net annual valuation deferred and uncollected premiums necessary to offset a corresponding increase in reserves attributable to deferred and uncollected premiums which has been done through the method of accounting so prescribed for the plaintiff. This method provides a corresponding offset for such increase in reserves. The inclusion of the increase in loading is unnecessary to accomplish this purpose and to otherwise include it in the premium income of the plaintiff would subject the plaintiff to income tax on items it has no right to receive. (T. 137-139).

13. The method of accounting prescribed for the plaintiff by the National Association of Insurance Commissioners and used by it in the tax years involved by which method the plaintiff includes in its premium income the gross deferred and uncollected premiums and deducts therefrom the increase in loading thereon provides only the amount of net annual valuation premiums in income as are necessary to offset the increase in reserves attributable thereto and is the proper method of reporting premium income for the plaintiff for the years here involved. (T. 137).

Conclusions of Law

1. That the method of accounting of the plaintiff in the preparation of its income tax returns for the years 1958 through 1962 inclusive was under an accrual method of accounting in accordance with the provisions of Sec. 818(a) of the Internal Revenue Code of 1954 and was also under

an accrual method of accounting as the same is contemplated by Sec. 451 of the Internal Revenue Code of 1954.

(Tr. 211)

2. That the deduction for increase in loading on deferred and uncollected premiums is not a deduction for anticipated future expenses but is merely an offset to avoid the overstatement of the premium income of the plaintiff in each of the taxable years. The plaintiff in determining its gain from operations should include only the amount of deferred and uncollected premiums necessary to offset the amount of increase in reserves incurred by reason of deferred and uncollected premiums and the inclusion of the increase in loading on the deferred and uncollected premiums constitutes an overstatement of the income of the plaintiff by that amount which is erroneous and should be excluded in determining the plaintiff's gain from operations in each of the tax years here involved.

3. That the method of accounting adopted by the plaintiff for the years 1958 through 1962 inclusive, clearly reflected its income and the inclusion of the increase in loading on the deferred and uncollected premiums in the tax years here involved constituted an overstatement of the gain from operations of the plaintiff and the consequential tax assessment thereon was unlawful.

4. That the plaintiff with respect to the deficiency assessments paid by it on March 4, 1964, shall have judgment for that portion of said deficiency assessments, with interest thereon from date paid, which is represented by the deficiencies determined by the Commissioner of Internal Revenue in contravention of the foregoing findings of fact and conclusions of law.

II.

LOADING ON DEFERRED AND UNCOLLECTED PREMIUMS AS ASSETS

Findings of Fact

1. The findings of fact of this Court respecting the issue of increase in load on deferred and uncollected premiums are applicable to this issue and are so found by this Court to be facts.

2. The plaintiff as required by law in making its Annual Statement for the end of each taxable year, computed its life insurance reserves on the assumption that on each policy anniversary the full annual premium has been received and in calculating such reserves, the full annual net valuation premium was used. (T. 83, 106).

3. The net annual valuation portion of the gross deferred and uncollected premiums is included in the life insurance reserves on the policies of the plaintiff. (T. 85).

(Tr. 212)

4. The plaintiff does not have a corresponding asset for this reserve liability as it has no legal right to collect the deferred and uncollected premiums, however the method of accounting prescribed by the National Association of Insurance Commissioners for the plaintiff provides for the offsetting of this portion of the reserve liability by an amount equal to the net annual valuation deferred and uncollected premiums which have not been received and this sum is entered as an asset of the plaintiff. This may be illustrated as follows:

(a) Reference is made to Pages 2 and 3 of the Annual Statement of the Plaintiff for 1960 (Joint Exhibit 25).

(b) On Line 1 of Page 3 which is the Statement of Liabilities of the plaintiff, there appears a reserve for life insurance policies in the sum of $425,000,000 (round figures). Of this sum, $20,000,000 (round figures) represents the portion of net annual valuation premiums not received during the taxable year and is deferred and uncollected. (T. 109).

(c) Although the plaintiff has no legal right to collect premiums covering the foregoing amount from its policyholders, it is permitted in its Annual Statement to set up an offsetting entry which appears on Line 17 on Page 2 of the Annual Statement in the form of an "asset" of $20,000,000 (round figures) on account of life insurance premiums deferred and uncollected. (T. 110).

(d) In arriving at the $20,000,000 asset figure, the plaintiff properly determined the gross amount of deferred and uncollected premiums and subtracted therefrom the loading thereon in order to determine the portion of the net annual valuation premiums to be used as an offset which offset is determined by the amount of reserve liability. (T. 104).

(e) In assessing the deficiency against the plaintiff, the Commissioner of Internal Revenue improperly asserted that Line 17 on Page 2 should have reflected the gross amount of deferred and uncollected premiums in the sum of $27,000,000 (round figures) which is the amount of the unpaid net annual valuation premiums used as an offset to the corresponding reserve plus loading thereon which ac-

tion by the Commissioner improperly increased the assets of the plaintiff by approximately $7,000,000. (T. 102).

(Tr. 213)

5. The plaintiff has no legal right to collect deferred and uncollected premiums and the inclusion of loading thereon in the statement of assets of the plaintiff would be an overstatement of the plaintiff's assets and a corresponding overstatement of the surplus of the plaintiff thereby distorting the financial statement of the plaintiff and would be improper. (T. 259, 543).

6. That in determining the assets of the plaintiff for calculation of its investment income, the loading on deferred and uncollected premiums is not to be considered an asset and inclusion of loading thereon in the assets of the plaintiff in the tax years here involved by the Commissioner of Internal Revenue was erroneous as only the net annual valuation portion of the deferred and uncollected premiums in an amount equal to the corresponding reserve liability constitutes assets of the plaintiff for purposes of determining the plaintiff's investment income.

Conclusions of Law

1. That the plaintiff properly followed the method of accounting prescribed for it by the National Association of Insurance Commissioners and its accounting was correctly made in accordance with the provisions of Sec. 818(a) of the Internal Revenue Code of 1954.

2. That the loading on deferred and uncollected premiums does not constitute an asset of the plaintiff for the purposes of determining its taxable investment income and

the inclusion of such loading in the assets of the plaintiff by the Commissioner of Internal Revenue in assessing deficiencies against the plaintiff for the tax years here involved was unlawful.

3. That the plaintiff, with respect to the deficiency assessments paid by it on March 4, 1964, is entitled to judgment for that portion of said deficiency assessments with interest thereon from date paid, which is represented by the deficiences determined by the Commissioner of Internal Revenue contravention of the foregoing findings of fact and conclusions of law.

III.

UNEARNED INVESTMENT INCOME ARISING FROM LOANS TO POLICYHOLDERS

Findings of Fact

(Tr. 214)

1. The life insurance policies and annuity contracts issued by the plaintiff, which have cash values, provide that a loan may be obtained on the sole security of the policy at any time that a cash value is available and while the policy is in force. Interest on policy loans is payable in advance at the time the loan is made to the end of the current policy year and annually thereafter on the policy anniversary for the ensuing year. If the interest on the policy loan is not paid when due, it is added to the principal of the existing loan and bears interest at the same rate.

2. The whole or any part of the indebtedness arising from a policy loan may be repaid at any time. If repay-

ment of a policy loan is made during the policy year, the exact amount of interest ratably earned by the plaintiff is retained by it and the residue is returned to the policyholder. If the policyholder should surrender his policy for the cash value then only the exact amount of prepaid interest ratably earned by the plaintiff is retained by it and the residue is returned to the policyholder. If the policyholder should die then only the exact amount of prepaid interest ratably earned by the plaintiff is retained by it and the residue is paid to the beneficiary of the policy along with the principal sum of the policy. (T. 391, 394).

3. This may be illustrated by assuming a $100 cash loan upon a policy having an anniversary of July 1 with an interest provision of 5%. The 5% interest payable in advance amounting to $5.00 at the time the initial loan is made creates an indebtedness of $105 with the policyholder receiving $100 in cash. On December 31 of the year in which the loan is made, the loan has earned $2.50 which the plaintiff properly treats as earned income and the remaining $2.50 is unearned income which is reflected in Line 17 on Page 3 of its Annual Statement. Continuing with this illustrative case, on July 1 of the next succeeding year, there is due and payable the sum of $5.00 (round figures) as interest on the policy loan for the next policy year. If the policyholder pays the sum of $5.00 on the loan for this next year, it is received as unearned investment income and is so treated by the plaintiff. On December 31 of that year, the plaintiff has readily determined that it has earned $2.50 of the $5.00 which is included in its investment income and the remaining $2.50 is not so included in investment income but is treated as unearned investment income. (T. 388-391).

(Tr. 215)

4. The insured has the right to pay off a policy loan at any time and if he makes payment of the policy loan he will receive a refund of the unearned investment income held by the plaintiff with the plaintiff retaining only the portion of the interest income actually earned. Under the foregoing example, if the insured should repay the loan on August 1, the plaintiff would retain only 1/12th of the $5.00 interest received and refund the residue to the insured. The insured may surrender his policy for its cash value at any time and under this example, if the insured should surrender his policy on August 1, the plaintiff would retain only 1/12th of the prepaid interest and treat the same as earned income and refund the residue to the insured as part of the net cash value payable to him. If the insured, in this example should die on August 1, then the plaintiff would retain only 1/12th of the interest received in advance paying over the residue to the named beneficiary as part of the death benefits. (T. 391).

5. The method of determining what portion of the prepaid interest belongs to the plaintiff as earned interest at the end of the calendar year and the portion which is unearned interest is determined in accordance with established accounting principles (T. 405, 554); the amount of unearned interest at the end of the year which may become earned by the plaintiff is undeterminable and is dependent upon whether the insured continues to live or whether he elects to repay the loan or surrender the policy for its cash value.

6. The interest received by the plaintiff from its policyholders is for the use of money which shall be provided

by the plaintiff over a specified period of time and consequently the interest, when received by the plaintiff, does not unconditionally belong to the plaintiff.

7. The plaintiff had on hand commercial non-interest-bearing bank deposits at the end of each of the taxable years involved herein which were far in excess of the bank deposits needed by the plaintiff to cover existing escrow accounts and the amounts of prepaid but unearned investment income; the bank accounts of the plaintiff for the respective years and the amount of unearned investment income at the end of each respective year were:

Year	*Amount of Unearned Investment Income*	*Amount of Bank Deposits*
1958	$ 672,837.68	$11,763,337.74
1959	937,486.32	10,765,626.31
1960	1,231,454.33	11,650,430.00
1961	1,418,046.98	11,729,734.64

(Tr. 216)

8. When a policyholder fails to pay the interest on a policy loan when due, the plaintiff, if there is sufficient cash value, capitalizes the amount of interest and adds it to the principal of the existing loan which may be illustrated by assuming a policy anniversary of July 1 and a policy loan in the sum of $100 made on that date. On the following July 1, the policy anniversary, there is due the plaintiff the sum of $5.00 as interest on the policy loan for the next ensuing year and if the policyholder does not pay the $5.00 interest when due, the plaintiff will add the sum to the principal of the loan thereby increasing the indebtedness on the policy. On December 31 of that year, $2.50 of the unpaid capitalized interest has become earned interest and

is treated by the plaintiff as part of its investment income and the plaintiff properly treats the remaining $2.50 as unearned investment income. The $2.50 which has been earned constitutes an indebtedness of the policyholder which together with the original indebtedness of $100 makes an indebtedness of $102.50 which is the sum the plaintiff has properly treated as an asset in determining its taxable investment income under Phase I. (T. 406-409). Under this example, if the insured should repay the loan on August 1, the plaintiff would treat only 1/12th of the capitalized interest as earned income and part of the policy indebtedness and would disregard the remaining 11/12ths; the same is true if the policyholder surrenders the policy for its cash surrender value on August 1; the same is true if the policyholder should die on August 1. When interest has been capitalized and added to the principal of the loan, it is entirely dependent upon the future action of the policyholder as to how much of the interest will actually be earned by the plaintiff and thereby constitute the principal amount of the loan. As interest is earned ratably day by day, it ratably becomes an increase in the policy indebtedness. (T. 407).

9. The plaintiff, at the end of each taxable year, determined the portion of the unpaid but capitalized interest which was earned and treated the earned portion as part of its taxable investment income and in determining its assets for Phase I computations, properly treated the earned portion of the unpaid capitalized interest as part of the indebtedness due from its policyholders and as an asset of the plaintiff.

10. The plaintiff's method of accounting in each of the taxable years was an accrual method of accounting and all

of its computations were made in a manner consistent with the manner required for the purposes of annual statements approved by the National Association of Insurance Commissioners.

(Tr. 217)

11. The plaintiff in and by its method of accounting properly determined at the end of each taxable year the amount of prepaid interest which was earned by it and so reflected the same in its Annual Statement for each of said years and the amount of prepaid interest so earned by the plaintiff in each of the taxable years constitutes taxable investment income of the plaintiff for the respective years and was so treated by the plaintiff in the preparation of its income tax return for each of the taxable years.

12. The plaintiff properly excluded from its income tax return for each of the taxable years, the amount of prepaid interest which had not been earned by it and this excluded portion did not constitute income of the plaintiff in the year received.

13. The plaintiff determined at the end of each taxable year the amount of unpaid but capitalized interest on the policy loans which had been earned by it and properly treated the same as earned investment income. Only the amount of such capitalized interest as had been earned by the plaintiff at the end of each taxable year is an asset of the plaintiff for such year and was so treated by the plaintiff and that portion of capitalized interest which has not been earned during the taxable year does not constitute an asset of the plaintiff for the taxable year.

14. The adjusted basis of a policy loan is the amount actually due and owing from an insured.

15. The Commissioner of Internal Revenue, in assessing a deficiency against the plaintiff did, with respect to interest received by the plaintiff in advance, improperly include in the year of such receipt the amount of interest which was not earned by the plaintiff during the year of receipt.

16. The Commissioner of Internal Revenue, in making his deficiency assessment against the plaintiff, improperly included in the assets of the plaintiff at the end of each taxable year that portion of unpaid but capitalized interest on policy loans which was not earned by the plaintiff at the end of each taxable year.

Conclusions of Law

(Tr. 218)

1. That the method of accounting of the plaintiff in the preparation of its income tax returns for the years 1958 through 1962 inclusive, was on an accrual method of accounting in accordance with the provisions of Sec. 818(a) of the Code, on an accrual method of accounting as the same is contemplated in Sec. 451 of the Code and on the method of accounting on the basis of which the plaintiff regularly computes its income in keeping its books and in compliance with Sec. 446(a) of the Code.

2. That the taxable income of the plaintiff for the years 1958 through 1962 inclusive was computed under the method of accounting on the basis of which the plaintiff regularly computes its income in keeping its books.

3. That the method of accounting adopted by the plaintiff for the years 1958 through 1962 inclusive, clearly reflected its income and it was an abuse of the discretion of the Commissioner of Internal Revenue granted to him by Sec. 446(b) of the Internal Revenue Code of 1954:

(a) To include in the taxable income of the plaintiff in each of the taxable years that portion of unearned investment income represented by interest received on policy loans which had not been ratably earned by the plaintiff during the taxable year, and

(b) To include in the assets of the plaintiff at the end of each taxable year that portion of unpaid but capitalized interest on policy loans which had not been earned by the plaintiff at the end of each taxable year.

4. That the Commissioner of Internal Revenue improperly adopted a hybrid method of accounting for the plaintiff partially on an accrual method and partially upon a cash receipts and disbursements method in contravention of Sec. 818(a)(2) of the Internal Revenue Code of 1954 which enjoins the Commissioner from using the cash receipts and disbursements method for determining the taxable income of a life insurance company.

5. That the plaintiff, with respect to the deficiency assessments paid by it on March 4, 1964, is entitled to judgment for that portion of said deficiency assessments with interest thereon from date paid, which is represented by the deficiencies determined by the Commissioner of Internal Revenue in contravention of the foregoing findings of fact and conclusions of law.

[Portions of Findings and Conclusions dealing with unrelated issues omitted]

* * * * *

Dated at Springfield, Illinois, this 15th day of June, 1967.

OMER POOS, *Chief Judge,*
United States District Court.

APPENDIX E

Statutes and Regulations

1. The pertinent provisions of the Life Insurance Company Tax Act of 1959 (Internal Revenue Code of 1954, Chapter 1, Subchapter L, Part I; Sections 801(a) and (b), 802, 804, 805(a), (b) and (c), 809, 810(a), (b) and (c), 811 and 818(a)) are as follows:

Subpart A—Definition; Tax Imposed

§ 801. **Definition of life insurance company**

(a) **Life insurance company defined.**—For purposes of this subtitle, the term "life insurance company" means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance), or noncancellable contracts of health and accident insurance, if—

(1) its life insurance reserves (as defined in subsection (b)), plus

(2) unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, health, or accident policies not included in life insurance reserves,

comprise more than 50 percent of its total reserves (as defined in subsection (c)).

(b) **Life insurance reserves defined.**—

(1) **In general.**—For purposes of this part, the term "life insurance reserves" means amounts—

(A) which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and

(B) which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies.

(2) **Reserves must be required by law.**—Except—

(A) in the case of policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation,

(B) in the case of policies issued by an organization which meets the requirements of section 501(c) (9) other than the requirement of subparagraph (B) thereof, and

(C) as provided in paragraph (3),

in addition to the requirements set forth in paragraph (1), life insurance reserves must be required by law.

(3) **Assessment companies.**—In the case of an assessment life insurance company or association, the term "life insurance reserves" includes—

(A) sums actually deposited by such company or association with State or Territorial officers pursuant to law as guaranty or reserve funds, and

(B) any funds maintained, under the charter or articles of incorporation or association (or by-laws approved by a State insurance commissioner) of such company or association, exclusively for the payment of claims arising under certificates of membership or policies issued on the assessment plan and not subject to any other use.

For purposes of this part, the rate of interest assumed in calculating the reserves described in subparagraphs (A) and (B) shall be 3 percent.

(4) **Deficiency reserves excluded.**—The term "life insurance reserves" does not include deficiency reserves. For purposes of this subsection and subsection (c), the deficiency reserve for any contract is that portion of the reserve for such contract equal to the amount (if any) by which—

(A) the present value of the future net premiums required for such contract, exceeds

(B) the present value of the future actual premiums and consideration charged for such contract.

(5) **Amount of reserves.**—For purposes of this subsection, subsection (a), and subsection (c), the amount of any reserve (or portion thereof) for any taxable year shall be the mean of such reserve (or portion thereof) at the beginning and end of the taxable year.

* * * * *

§ 802. **Tax imposed**

(a) **Tax imposed.—**

(1) **In general.**—A tax is hereby imposed for each taxable year beginning after December 31, 1957, on the life insurance company taxable income of every life insurance company. Such tax shall consist of a normal tax and surtax computed as provided in section 11 as though the life insurance company taxable income were the taxable income referred to in section 11.

(2) **Alternative tax in case of capital gains.**—If for any taxable year beginning after December 31, 1961, the net long-term capital gain of any life insurance company exceeds the net short-term capital loss, then, in lieu of the tax imposed by paragraph (1), there is hereby imposed a tax (if such tax is less than the tax imposed by such paragraph) which shall consist of the sum of—

(A) a partial tax, computed as provided by paragraph (1), on the life insurance company taxable income determined by reducing the taxable investment income, and the gain from operations, by the amount of such excess, and

(B) an amount equal to 25 percent of such excess.

(3) **Special rule for 1959 and 1960.**—If any amount is subtracted from the policyholders surplus account under section 815(c) (3) for a taxable year beginning in 1959 or 1960 on account of a distribution in 1959 or 1960 (not including any distribution treated under section 815(d) (2) (B) as made in 1959 or 1960), the tax imposed for such taxable year on the life insurance

company taxable income shall be the amount determined under paragraph (1) reduced by the following percentage of the amount by which the tax imposed by paragraph (1) is (without regard to this paragraph) increased, on account of the amount so subtracted, by reason of section 802(b) (3),--

(A) in the case of a taxable year beginning in 1959, 66⅔ percent; and

(B) in the case of a taxable year beginning in 1960, 33⅓ percent.

The preceding sentence shall not apply with respect to any payment treated as a distribution under section 815(d) (3).

(b) **Life insurance company taxable income defined.**--For purposes of this part, the term "life insurance company taxable income" means the sum of—

(1) the taxable investment income (as defined in section 804) or, if smaller, the gain from operations (as defined in section 809),

(2) if the gain from operations exceeds the taxable investment income, an amount equal to 50 percent of such excess, plus

(3) the amount subtracted from the policyholders surplus account for the taxable year, as determined under section 815.

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Subpart B—Investment Income

§ 804. Taxable investment income

(a) In general.—

(1) Exclusion of policyholders' share of investment yield.—The policyholders' share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received) of any life insurance company shall not be included in taxable investment income. For purposes of the preceding sentence, the policyholders' share of any item shall be that percentage obtained by dividing the policy and other contract liability requirements by the investment yield; except that if the policy and other contract liability requirements exceed the investment yield, then the policyholders' share of any item shall be 100 percent.

(2) Taxable investment income defined.—For purposes of this part, the taxable investment income for any taxable year shall be an amount (not less than zero) equal to the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss plus the sum of the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received), reduced by—

(A) the sum of—

(i) the life insurance company's share of interest which under section 103 is excluded from gross income,

(ii) the deduction for partially tax-exempt interest provided by section 242 (as modified by paragraph (3)), computed with respect to the life insurance company's share of such interest, and

(iii) the deductions for dividends received provided by sections 243, 244, and 245 (as modified by paragraph (5)) computed with respect to the life insurance company's share of the dividends received; and

(B) the small business deduction provided by paragraph (4).

For purposes of the preceding sentence, the life insurance company's share of any item shall be that percentage which, when added to the percentage obtained under the second sentence of paragraph (1), equals 100 percent.

(3) **Partially tax-exempt interest.**—For purposes of this part, the deduction allowed by section 242 shall be an amount which bears the same ratio to the amount determined under such section without regard to this paragraph as (A) the normal tax rate for the taxable year prescribed by section 11, bears to (B) the sum of the normal tax rate and the surtax rate for the taxable year prescribed by section 11.

(4) **Small business deduction.**—For purposes of this part, the small business deduction is an amount equal to 10 percent of the investment yield for the taxable year. The deduction under this paragraph shall not exceed $25,000.

(5) **Application of section 246(b).**—In applying section 246(b) (relating to limitation on aggregate amount of deductions for dividends received) for purposes of this subsection, the limit on the aggregate amount of the deductions allowed by sections 243(a)(1), 244(a), and 245 shall be 85 percent of the taxable investment income computed without regard to the deductions allowed by such sections.

(6) **Exception.**—If it is established in any case that the application of the definition of taxable investment income contained in paragraph (2) results in the imposition of tax on—

(A) any interest which under section 103 is excluded from gross income,

(B) any amount of interest which under section 242 (as modified by paragraph (3)) is allowable as a deduction, or

(C) any amount of dividends received which under sections 243, 244, and 245 (as modified by paragraph (5)) is allowable as a deduction,

adjustment shall be made to the extent necessary to prevent such imposition.

(b) **Gross investment income.**—For purposes of this part, the term "gross investment income" means the sum of the following:

(1) **Interest, etc.**—The gross amount of income from—

(A) interest dividends, rents, and royalties,

(B) the entering into of any lease, mortgage, or other instrument or agreement from which the life insurance company derives interest, rents, or royalties, and

(C) the alteration or termination of any instrument or agreement described in subparagraph (B).

(2) **Short-term capital gain.**—In the case of a taxable year beginning after December 31, 1958, the amount (if any) by which the net short-term capital gain exceeds the net long-term capital loss.

(3) **Trade or business income.**—The gross income from any trade or business (other than an insurance business) carried on by the life insurance company, or by a partnership of which the life insurance company is a partner. In computing gross income under this paragraph, there shall be excluded any item described in paragraph (1).

Except as provided in paragraph (2), in computing gross investment income under this subsection, there shall be excluded any gain from the sale or exchange of a capital asset, and any gain considered as gain from the sale or exchange of a capital asset.

(c) **Investment yield defined.**—For purposes of this part, the term "investment yield" means the gross investment income less the following deductions—

(1) **Investment expenses.**—Investment expenses for the taxable year. If any general expenses are in part assigned to or included in the investment expenses,

the total deduction under this paragraph shall not exceed the sum of—

(A) one-fourth of one percent of the mean of the assets (as defined in section 805(b) (4)) held at the beginning and end of the taxable year,

(B) the amount of the mortgage service fees for the taxable year, plus

(C) whichever of the following is the greater:

(i) one-fourth of the amount by which the investment yield (computed without any deduction for investment expenses allowed by this paragraph) exceeds 3¾ percent of the mean of the assets (as defined in section 805(b) (4)) held at the beginning and end of the taxable year, reduced by the amount described in subparagraph (B), or

(ii) one-fourth of one percent of the mean of the value of mortgages held at the beginning and end of the taxable year for which there are no mortgage service fees for the taxable year.

(2) **Real estate expenses.**—The amount of taxes (as provided in section 164), and other expenses, for the taxable year exclusively on or with respect to the real estate owned by the company. No deduction shall be allowed under this paragraph for any amount paid out for new buildings, or for permanent improvements or betterments made to increase the value of any property.

(3) **Depreciation.**—The deduction allowed by section 167. The deduction under this paragraph and paragraph (2) on account of any real estate owned and occupied for insurance purposes in whole or in part by a life insurance company shall be limited to an amount which bears the same ratio to such deduction (computed without regard to this sentence) as the rental value of the space not so occupied bears to the rental value of the entire property.

(4) **Depletion.**—The deduction allowed by section 611 (relating to depletion).

(5) **Trade or business deductions.**—The deductions allowed by this subtitle (without regard to this part) which are attributable to any trade or business (other than an insurance business) carried on by the life insurance company, or by a partnership of which the life insurance company is a partner; except that in computing the deduction under this paragraph—

(A) There shall be excluded losses—

(i) from (or considered as from) sales or exchanges of capital assets,

(ii) from sales or exchanges of property used in the trade or business (as defined in section 1231(b)), and

(iii) from the compulsory or involuntary conversion (as a result of destruction, in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business (as so defined).

(B) Any item, to the extent attributable to the carrying on of the insurance business, shall not be taken into account.

(C) The deduction for net operating losses provided in section 172, and the special deductions for corporations provided in part VIII of subchapter B, shall not be allowed.

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§ 805. **Policy and other contract liability requirements**

(a) **In general.**—For purposes of this part, the term "policy and other contract liability requirements" means, for any taxable year, the sum of—

(1) the adjusted life insurance reserves, multiplied by the adjusted reserves rate,

(2) the mean of the pension plan reserves at the beginning and end of the taxable year, multiplied by the current earnings rate, and

(3) the interest paid.

(b) **Adjusted reserves rate and earnings rates.**—

(1) **Adjusted reserves rate.**—For purposes of this part, the adjusted reserves rate for any taxable year is the average earnings rate or, if lower, the current earnings rate.

(2) **Current earnings rate.**—For purposes of this part, the current earnings rate for any taxable year is the amount determined by dividing—

(A) the taxpayer's investment yield for such taxable year, by

(B) the mean of the taxpayer's assets at the beginning and end of the taxable year.

(3) **Average earnings rate.**—

(A) **In general.**—For purposes of this part, the average earnings rate for any taxable year is the average of the current earnings rates for such taxable year and for each of the 4 taxable years immediately preceding such taxable year (excluding any of such 4 taxable years for which the taxpayer was not an insurance company).

(B) **Special rules.**—For purposes of subparagraph (A)—

(i) the current earnings rate for any taxable year beginning before January 1, 1958, shall be determined as if this part (as in effect for 1958) and section 381(c) (22) applied to such taxable year, and

(ii) the current earnings rate for any taxable year of any company which, for such year, is an insurance company (but not a life insurance company) shall be determined as if this part applied to such company for such year.

(4) **Assets.**—For purposes of this part, the term "assets" means all assets of the company (including nonadmitted assets), other than real and personal property (excluding money) used by it in carrying on an insurance trade or business. For purposes of this paragraph, the amount attributable to—

(A) real property and stock shall be the fair market value thereof, and

(B) any other asset shall be the adjusted basis (determined without regard to fair market value

on December 31, 1958), of such asset for purposes of determining gain on sale or other disposition.

(c) **Adjusted life insurance reserves.**—

(1) **Adjusted life insurance reserves defined.**—For purposes of this part, the term "adjusted life insurance reserves" means—

(A) the mean of the life insurance reserves (as defined in section 801(b)), other than pension plan reserves, at the beginning and end of the taxable year, multiplied by

(B) that percentage which equals 100 percent—

(i) increased by that percentage which is 10 times the average rate of interest assumed by the taxpayer in calculating such reserves, and

(ii) reduced by that percentage which is 10 times the adjusted reserves rate.

(2) **Average interest rate assumed.**—For purposes of this part, the average rate of interest assumed in calculating reserves shall be computed—

(A) by multiplying each assumed rate of interest by the means of the amounts of such reserves computed at that rate at the beginning and end of the taxable year, and

(B) by dividing (i) the sum of the products ascertained under subparagraph (A), by (ii) the mean of the total of such reserves at the beginning and end of the taxable year.

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Subpart C—Gain and Loss From Operations

§ 809. **In general**

(a) **Exclusion of share of investment yield set aside for policyholders.—**

(1) **Amount.**—The share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received) of any life insurance company set aside for policyholders shall not be included in gain or loss from operations. For purposes of the preceding sentence, the share of any item set aside for policyholders shall be that percentage obtained by dividing the required interest by the investment yield; except that if the required interest exceeds the investment yield, then the share of any item set aside for policyholders shall be 100 percent.

(2) **Required interest.**—For purposes of this part, the required interest for any taxable year is the sum of the products obtained by multiplying—

(A) each rate of interest required, or assumed by the taxpayer, in calculating the reserves described in section 810(c), by

(B) the means of the amount of such reserves computed at that rate at the beginning and end of the taxable year.

(b) **Gain and loss from operations.—**

(1) **Gain from operations defined.**—For purposes of this part, the term "gain from operations" means the amount by which the sum of the following exceeds the deductions provided by subsection (d):

(A) the life insurance company's share of each and every item of investment yield (including tax exempt interest, partially tax exempt interest, and dividends received);

(B) the amount (if any) by which the net long term capital gain exceeds the net short term capital loss; and

(C) the sum of the items referred to in subsection (c).

(2) **Loss from operations defined.**—For purposes of this part, the term "loss from operations" means the amount by which the sum of the deductions provided by subsection (d) exceeds the sum of—

(A) the life insurance company's share of each and every item of investment yield (including tax exempt interest, partially tax exempt interest, and dividends received);

(B) the amount (if any) by which the net long term capital gain exceeds the net short term capital loss; and

(C) the sum of the items referred to in subsection (c).

(3) **Life insurance company's share.**—For purposes of this subpart, the life insurance company's share of any item shall be that percentage which, when added to the percentage obtained under the second sentence of subsection (a) (1), equals 100 percent.

(4) **Exception.**—If it is established in any case that the application of the definition of gain from oper-

ations contained in paragraph (1) results in the imposition of tax on

(A) any interest which under section 103 is excluded from gross income,

(B) any amount of interest which under section 242 (as modified by section 804(a)(3)) is allowable as a deduction, or

(C) any amount of dividends received which under sections 243, 244, and 245 (as modified by subsection (d)(8)(B)) is allowable as a deduction,

adjustment shall be made to the extent necessary to prevent such imposition.

(c) **Gross amount.**—For purposes of subsections (b)(1) and (2), the following items shall be taken into account:

(1) **Premiums.**—The gross amount of premiums and other consideration (including advance premiums, deposits, fees, assessments, and consideration in respect of assuming liabilities under contracts not issued by the taxpayer) on insurance and annuity contracts (including contracts supplementary thereto); less return premiums, and premiums and other consideration arising out of reinsurance ceded. Except in the case of amounts of premiums or other consideration returned to another life insurance company in respect of reinsurance ceded, amounts returned where the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management shall not be included in return premiums.

(2) **Decreases in certain reserves.**—Each net decrease in reserves which is required by section 810 or 811(b) (2) to be taken into account for purposes of this paragraph.

(3) **Other amounts.**—All amounts, not included in computing investment yield and not includible under paragraph (1) or (2), which under this subtitle are includible in gross income.

Except as included in computing investment yield, there shall be excluded any gain from the sale or exchange of a capital asset, and any gain considered as gain from the sale or exchange of a capital asset.

(d) **Deductions.**—For purposes of subsections (b) (1) and (2), there shall be allowed the following deductions:

(1) **Death benefits, etc.**—All claims and benefits accrued, and all losses incurred (whether or not ascertained), during the taxable year on insurance and annuity contracts (including contracts supplementary thereto).

(2) **Increases in certain reserves.**—The net increase in reserves which is required by section 810 to be taken into account for purposes of this paragraph.

(3) **Dividends to policyholders.**—The deduction for dividends to policyholders (determined under section 811(b)).

(4) **Operations loss deduction.**—The operations loss deduction (determined under section 812).

(5) **Certain nonparticipating contracts.**—An amount equal to 10 percent of the increase for the taxable year

in the reserves for nonparticipating contracts or (if greater) an amount equal to 3 percent of the premiums for the taxable year (excluding that portion of the premiums which is allocable to annuity features) attributable to nonparticipating contracts (other than group contracts) which are issued or renewed for periods of 5 years or more. For purposes of this paragraph, the term "reserves for nonparticipating contracts" means such part of the life insurance reserves (excluding that portion of the reserves which is allocable to annuity features) as relates to nonparticipating contracts (other than group contracts). For purposes of this paragraph and paragraph (6), the term "premiums" means the net amount of the premiums and other consideration taken into account under subsection (c) (1).

(6) **Certain accident and health insurance and group life insurance.**—An amount equal to 2 percent of the premiums for the taxable year attributable to accident and health insurance contracts (other than those to which paragraph (5) applies) and group life insurance contracts. The deduction under this paragraph for the taxable year and all preceding taxable years shall not exceed an amount equal to 50 percent of the premiums for the taxable year attributable to such contracts.

(7) **Assumption by another person of liabilities under insurance, etc., contracts.**—The consideration (other than consideration arising out of reinsurance ceded) in respect of the assumption by another person of liabilities under insurance and annuity contracts (including contracts supplementary thereto).

(8) **Tax-exempt interest, dividends, etc.**—

(A) **Life insurance company's share.**—Each of the following items:

(i) the life insurance company's share of interest which under section 103 is excluded from gross income,

(ii) the deduction for partially tax-exempt interest provided by section 242 (as modified by section 804(a) (3)) computed with respect to the life insurance company's share of such interest, and

(iii) the deductions for dividends received provided by sections 243, 244, and 245 (as modified by subparagraph (B)) computed with respect to the life insurance company's share of the dividends received.

(B) **Application of section 246(b).**—In applying section 246(b) (relating to limitation on aggregate amount of deductions for dividends received) for purposes of subparagraph (A) (iii), the limit on the aggregate amount of the deductions allowed by sections 243(a) (1), 244(a), and 245 shall be 85 percent of the gain from operations computed without regard to—

(i) the deductions provided by paragraphs (3), (5), and (6) of this subsection,

(ii) the operations loss deduction provided by section 812, and

(iii) the deductions allowed by sections 243(a) (1), 244(a), and 245,

but such limit shall not apply for any taxable year for which there is a loss from operations.

(9) **Investment expenses, etc.**—Investment expenses to the extent not allowed as a deduction under section 804(c) (1) in computing investment yield, and the amount (if any) by which the sum of the deductions allowable under section 804(c) exceeds the gross investment income.

(10) **Small business deduction.**—A small business deduction in an amount equal to the amount determined under section 804(a) (4).

(11) **Certain mutualization distributions.** — The amount of distributions to shareholders made in 1958, 1959, 1960, 1961, and 1962 in acquisition of stock pursuant to a plan of mutualization adopted before January 1, 1958.

(12) **Other deductions.**—Subject to the modifications provided by subsection (e), all other deductions allowed under this subtitle for purposes of computing taxable income to the extent not allowed as deductions in computing investment yield.

Except as provided in paragraph (3), no amount shall be allowed as a deduction under this subsection in respect of dividends to policyholders.

(e) **Modifications.**—The modifications referred to in subsection (d) (12) are as follows:

(1) **Interest.**—In applying section 163 (relating to deduction for interest), no deduction shall be allowed for interest in respect of items described in section 810(c).

(2) **Bad debts.**—Section 166(c) (relating to reserve for bad debts) shall not apply.

(3) **Charitable, etc., contributions and gifts.**—In applying section 170—

(A) the limit on the total deductions under such section provided by the first sentence of section 170(b) (2) shall be 5 percent of the gain from operations computed without regard to—

(i) the deduction provided by section 170,

(ii) the deductions provided by paragraphs (3), (5), (6), and (8) of subsection (d), and

(iii) any operations loss carryback to the taxable year under section 812; and

(B) under regulations prescribed by the Secretary or his delegate, a rule similar to the rule contained in section 170(b) (3) shall be applied.

(4) **Amortizable bond premium.**—Section 171 shall not apply.

(5) **Net operating loss deduction.**—The deduction for net operating losses provided in section 172 shall not be allowed.

(6) **Partially tax-exempt interest.**—The deduction for partially tax-exempt interest provided by section 242 shall not be allowed.

(7) **Dividends received.**—The deductions for dividends received provided by sections 243, 244, and 245 shall not be allowed.

(f) **Limitations on certain deductions.**—

(1) **In general.**—The amount of the deductions under paragraphs (3), (5), and (6) of subsection (d) shall not exceed $250,000 plus the amount (if any) by which—

(A) the gain from operations for the taxable year, computed without regard to such deductions, exceeds

(B) the taxable investment income for the taxable year.

(2) **Application of limitation.**—The limitation provided by paragraph (1) shall apply first to the amount of the deduction under subsection (d) (3), then to the amount of the deduction under subsection (d) (6), and finally to the amount of the deduction under subsection (d) (5).

(g) **Limitations on deduction for certain mutualization distributions.**—

(1) **Deduction not to reduce taxable investment income.**—The amount of the deduction under subsection (d) (11) shall not exceed the amount (if any) by which—

(A) the gain from operations for the taxable year, computed without regard to such deduction (but after the application of subsection (f)), exceeds

(B) the taxable investment income for the taxable year.

(2) **Deduction not to reduce tax below 1957 law.**—The deduction under subsection (d) (11) for the taxable year shall be allowed only to the extent that such deduction (after the application of all other deductions provided by subsection (d)) does not reduce the amount of the tax imposed by section 802(a) (1) for such taxable year below the amount of tax which would have been imposed by section 802(a) as in effect for 1957, if this part, as in effect for 1957, applied for such taxable year.

(3) **Application of section 815.**—That portion of any distribution with respect to which a deduction is allowed under subsection (d) (11) shall not be treated as a distribution to shareholders for purposes of section 815; except that in the case of any distribution made in 1959, 1960, 1961, or 1962, such portion shall be treated as a distribution with respect to which a reduction is required under section 815(c) (2) (B).

§ 810. **Rules for certain reserves**

(a) **Adjustment for decrease.**—If the sum of the items described in subsection (c) as of the beginning of the taxable year exceeds the sum of such items as of the close of the taxable year (reduced by the amount of investment yield not included in gain or loss from operations for the taxable year by reason of section 809(a) (1)), the excess shall be taken into account as a net decrease referred to in section 809(c) (2).

(b) **Adjustment for increase.**—If the sum of the items described in subsection (c) as of the close of the taxable year (reduced by the amount of investment yield not included in gain or loss from operations for the taxable year

by reason of section 809(a) (1)) exceeds the sum of such items as of the beginning of the taxable year, the excess shall be taken into account as a net increase referred to in section 809(d) (2).

(c) **Items taken into account.**—The items referred to in subsections (a) and (b) are as follows:

(1) The life insurance reserves (as defined in section 801(b)).

(2) The unearned premiums and unpaid losses included in total reserves under section 801(c) (2).

(3) The amounts (discounted at the rates of interest assumed by the company) necessary to satisfy the obligations under insurance or annuity contracts (including contracts supplementary thereto), but only if such obligations do not involve (at the time with respect to which the computation is made under this paragraph) life, health, or accident contingencies.

(4) Dividend accumulations, and other amounts, held at interest in connection with insurance or annuity contracts (including contracts supplementary thereto).

(5) Premiums received in advance, and liabilities for premium deposit funds.

In applying this subsection, the same item shall be counted only once.

• • • • •

§ 811. **Dividends to policyholders**

(a) **Dividends to policyholders defined.**—For purposes of this part, the term "dividends to policyholders" means

dividends and similar distributions to policyholders in their capacity as such. Such term does not include interest paid (as defined in section 805(e)).

(b) **Amount of deduction.**—

(1) **In general.**—Except as limited by section 809(f), the deduction for dividends to policyholders for any taxable year shall be an amount equal to the dividends to policyholders

(A) increased by the excess of (i) the amounts held at the end of the taxable year as reserves for dividends to policyholders (as defined in subsection (a)) payable during the year following the taxable year, over (ii) such amounts held at the end of the preceding taxable year, or

(B) decreased by the excess of (i) such amounts held at the end of the preceding taxable year, over (ii) such amounts held at the end of the taxable year.

For purposes of subparagraphs (A) and (B), there shall be included as amounts held at the end of any taxable year amounts set aside, before the 16th day of the third month of the year following such taxable year (or, in the case of a mutual savings bank subject to the tax imposed by section 594, before the 16th day of the fourth month of the year following such taxable year), for payment during the year following such taxable year.

(2) **Certain amounts to be treated as net decreases.**—If the amount determined under paragraph (1) (B) exceeds the dividends to policyholders paid during the

taxable year, the amount of such excess shall be a net decrease referred to in section 809(c) (2).

* * * * *

Subpart E—Miscellaneous Provisions

* * * * *

§ 818. Accounting provisions

(a) Method of accounting.—All computations entering into the determination of the taxes imposed by this part shall be made—

(1) under an accrual method of accounting, or

(2) to the extent permitted under regulations prescribed by the Secretary or his delegate, under a combination of an accrual method of accounting with any other method permitted by this chapter (other than the cash receipts and disbursements method).

Except as provided in the preceding sentence, all such computations shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.

* * * * *

2. Sections 446(a), (b) and (c) and 451(a) of the Internal Revenue Code of 1954, are as follows:

§ 446. General rule for methods of accounting

(a) General rule.—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) **Exceptions.**—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.

(c) **Permissible methods.**—Subject to the provisions of [redacted] income under any of the following methods of accounting—

(1) the cash receipts and disbursements method;

(2) an accrual method;

(3) any other method permitted by this chapter; or

(4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary or his delegate.

• • • • •

§ 451. **General rule for taxable year of inclusion**

(a) **General rule.**—The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

• • • • •

3. **Sections 1.809-4 and 1.818-2 of the Treasury Regulations, in pertinent part, read as follows:**

§ 1.809-4 **Gross amount**

(a) **Items taken into account.** For purposes of determining gain or loss from operations under section 809(b) (1)

and (2), respectively, section 809(c) specifies three categories of items which shall be taken into account. Such items are in addition to the life insurance company's share of the investment yield (as determined under section 809 (a) (1) and paragraph (c) of § 1.809-2), and the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss (such capital gains item is included in determining gain or loss from operations only for taxable years beginning after December 31, 1957). The additional three categories of items taken into account are:

(1) **Premiums.** (i) The gross amount of all premiums and other consideration on insurance and annuity contracts (including contracts supplementary thereto); less return premiums and premiums and other consideration arising out of reinsurance ceded. The term "gross amount of all premiums" means the premiums and other consideration provided in the insurance or annuity contract. Thus, the amount to be taken into account shall be the total of the premiums and other consideration provided in the insurance or annuity contract without any deduction for commissions, return premiums, reinsurance, dividends to policyholders, dividends left on deposit with the company, discounts on premiums paid in advance, interest applied in reduction of premiums (whether or not required to be credited in reduction of premiums under the terms of the contract), or any other item of similar nature. Such term includes advance premiums, premiums deferred and uncollected and premiums due and unpaid, deposits, fees, assessments, and consideration in respect of assuming liabilities under contracts not issued by the taxpayer (such as a payment or transfer of property in an assumption reinsurance transaction as defined in paragraph (a) (7) (ii) of

§ 1.809-5). The term also includes amounts a life insurance company charges itself representing premiums with respect to liability for insurance and annuity benefits for its employees (including full-time life insurance salesmen within the meaning of section 7701(a) (20)).

(ii) The term "return premiums" means amounts returned or credited which are fixed by contract and do not depend [redacted] refunded due to policy cancellations or erroneously computed premiums. Furthermore, amounts of premiums or other consideration returned to another life insurance company in respect of reinsurance ceded shall be included in return premiums. For the treatment of amounts which do not meet the requirements of return premiums, see section 811 (relating to dividends to policyholders).

(iii) For purposes of section 809(c) (1) and this subparagraph, the term "reinsurance ceded" means an arrangement whereby the taxpayer (the reinsured) remains solely liable to the policyholder, whether all or only a portion of the risk has been transferred to the reinsurer. Such term includes indemnity reinsurance transactions but does not include assumption reinsurance transactions. See paragraph (a) (7) (ii) of § 1.809-5 for the definition of assumption reinsurance.

• • • • •

§ 1.818-2 **Accounting provisions**

(a) **Method of accounting.** (1) Section 818(a) (1) provides the general rule that all computations entering into the determination of taxes imposed by part I, subchapter L, chapter 1 of the Code, shall be made under an accrual

method of accounting. Thus, the over-all method of accounting for life insurance companies shall be the accrual method. Except as otherwise provided in part I, the term "accrual method" shall have the same meaning and application of section 818 as it does under section 446 (relating to general rule for methods of accounting) and the regulations thereunder. For general rules relating to the taxable year for inclusion of income and deduction of items under an accrual method of accounting, see sections 451 and 461 and the regulations thereunder.

(2) Section 818(a) (2) provides that, to the extent permitted under this section, a life insurance company's method of accounting may be a combination of the accrual method with any other method of accounting permitted by chapter 1 of the Internal Revenue Code of 1954, other than the cash receipts and disbursements method. Thus, section 818(a) (2) specifically prohibits the use by a life insurance company of the cash receipts and disbursements method either separately or in combination with a permissible method of accounting. The term "method of accounting" includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item. For purposes of section 818(a) (2), a life insurance company may elect to compute its taxable income under an over-all method of accounting consisting of the accrual method combined with the special methods of accounting for particular items of income and expense provided under other sections of chapter 1 of the Internal Revenue Code of 1954, other than the cash receipts and disbursements method. These methods of accounting for special items include the accounting treatment provided for depreciation (section 167), research and experimental expenditures (sec-

tion 174), soil and water conservation expenditures (section 175), organizational expenditures (section 248), etc. In addition, a life insurance company may, where applicable, use the crop method of accounting (as provided in the regulations under sections 61 and 162), and the installment method of accounting for sales of realty and casual sales of personalty (as provided in section 453(b)). To the extent not inconsistent with the provisions of the Internal Revenue Code of 1954 or the regulations thereunder and the method of accounting adopted by the taxpayer pursuant to this section, all computations entering into the determination of taxes imposed by part I shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1968

No. 780

THE FRANKLIN LIFE INSURANCE COMPANY, Petitioner,

v.

UNITED STATES OF AMERICA, *Respondent.*

BRIEF AMICUS CURIAE OF AMERICAN LIFE CONVENTION IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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November, 1968

PRESS OF BYRON S. ADAMS PRINTING, INC., WASHINGTON, D. C.

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Statement of Interest of the Amicus

The American Life Convention, filing this brief amicus curiae, is a nonprofit voluntary trade association organized in 1906. It is the oldest international association of life insurance companies. Its membership comprises 350 legal reserve life insurance companies located in 45 states, the District of Columbia, and three provinces of Canada. These companies represent 91 per cent of the legal reserve life insurance

in force in the United States and Canada. The organization deals with problems affecting the interests of legal reserve life insurance companies and their policyholders.

This case involves the construction of the Internal Revenue Code, as amended by the Life Insurance Company Income Tax Act of 1959 (Pub. L. No. 86-69, 73 Stat. 112; Sections 801-820, Internal Revenue Code of 1954, as amended), such Act being hereinafter referred to as the 1959 Act. The 1959 Act for the first time since 1921 taxes life insurance companies on the basis of an annual determination of income from all sources. The decision in this case is the first decision under the 1959 Act by a United States Court of Appeals construing the methods of accounting to be followed by a life insurance company in computing its annual income subject to Federal income tax.

The 1959 Act added Section 818(a) to the Internal Revenue Code of 1954, which Section required life insurance companies to follow an accrual method of accounting. The United States Court of Appeals for the Seventh Circuit held that Petitioner was required to include in income the gross amount of deferred and uncollected premiums, an expectancy of income which it had not received and had no right to receive. This holding is in conflict with principles of tax accrual accounting prescribed by this Court for other taxpayers. The Court also held that petitioner was required to include in income advance interest which had not been earned, contrary to the tax treatment accorded other financial institutions.

The issues thus considered by the Court of Appeals affect significantly the Federal income tax computa-

tion of almost every life insurance company, most of whose tax returns are "open" for the years after 1957, the effective date of the 1959 Act. Large aggregate amounts of liability are involved.[1] It may be expected that the present differences between the Internal Revenue Service (hereinafter "IRS") positions and those of life insurance company taxpayers will remain unsettled until this Court resolves them. In the meantime, the uncertainty of the ultimate outcome of these issues is crippling the orderly administration of the Federal income tax laws for the life insurance industry. The Amicus, accordingly, submits this brief amicus curiae in support of the Petition for a Writ of Certiorari in the *Franklin Life* case and urges that the Writ be granted for the reasons set forth below.

The consent of the parties to the filing of this brief amicus curiae has been filed with the Clerk of the Court.

Opinions Below, Jurisdiction and the Statutes Involved

The Amicus respectfully refers the Court to the Petition for the statement of the Opinions Below, Jurisdiction, and Statutes Involved.

Questions Presented

1. Under the accrual method of accounting provided by the 1959 Act, must a life insurance company include in income in a year prior to its receipt—and treat as an asset—an amount of deferred and uncollected premiums which the company has no legal right to collect?

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[1] Petition 25, 26.

2. Must a life insurance company, unlike other financial institutions, include in income advance interest prior to the year it is earned; and report as an asset the amount of capitalized interest which is neither received nor earned?

Statement

The Amicus respectfully refers the Court, for a full statement of the issues presented, to the Petition and here indicates only sufficient detail for clarity of its brief argument.

1. *Premiums Deferred and Uncollected*—Life insurance premiums and the related reserves, as a consequence of mortality tables presented in yearly increments of death, are calculated by Petitioner on a policy-year basis. Premiums are charged to policy owners in most cases, however, on a quarterly or more frequent basis. At the end of each taxable year the life insurance company, therefore, has in force insurance policies with fractional premiums which are not "due" until the subsequent year, as well as policies with premiums "due" and unpaid but within the grace period. All such premiums are payable at the election of policy owners and the insurance company has no right to have them paid. These two classes of premiums constitute Petitioner's "premiums deferred and uncollected".

The Court of Appeals adopted the IRS position, reversing the District Court, and held that the gross amount of deferred and uncollected premiums must be included in income. The Petitioner's books of account, as presented in its "Annual Statements" in accordance with applicable State regulations, include the

increase in reserves related to premiums deferred and uncollected as a debit item and simply cancel the effect of including this debit item by offsetting against it the net valuation premium with respect to premiums deferred and uncollected. This "net valuation premium" is in an amount which exactly offsets the reserve increase which relates to the premiums deferred and uncollected. The subtractive difference between this net valuation premium and the gross amount of premiums deferred and uncollected is termed the "loading" thereon. As set forth in the Petition (see note 10, page 9), it is really the "loading" on the premiums deferred and uncollected which is in issue as to this point.

Further, the Court of Appeals adopted the IRS position, reversing the District Court, and held that the amount of such "loading" at year end should be included in the valuation of assets for purposes of the investment income formula of the 1959 Act. The Court's opinion failed to deal expressly with the relevant Code Section (805(b)), which requires the amount of any asset valued in the investment income formula (other than real property and stock) to be its cost basis for tax purposes.

2. *Unearned Interest*—Life insurance companies, in making loans on the security of the cash value of policies, may receive each year's interest in advance or may capitalize a year's interest by adding it to the principal of a loan when made. If a policyholder repays the loan before the end of a year for which interest was received or capitalized, the life insurance company credits him with a pro rata share of interest representing the unearned amount. The IRS required inclusion in income of advance policy loan interest not yet earned; and also required that amounts not received

or earned, but capitalized, should be included in the valuation of assets.

The Court of Appeals reversed the District Court in an opinion concurring with the IRS position on each point. The Court of Appeals held that the IRS was free to reject the deferral of unearned items in order to "clearly reflect income" under Section 446(b) of the Internal Revenue Code. This conclusion was applied to the valuation as an asset of interest not prepaid but capitalized.

Reasons Why the Amicus Believes the Writ Should Be Granted

1. In *Schlude* v. *Commissioner,* 372 U.S. 128 (1963), this Court remanded with instructions to permit deferral by an accrual-method taxpayer of precisely the form of future income expectancy in question here: amounts which are neither earned, due nor received.[2] If under the *Schlude* decision the increase in loading

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[2] In *Schlude* v. *Commissioner,* taxpayers operated a studio offering dancing lessons under contracts providing for a cash down payment with the balance payable in installments or by a negotiable note. The contracts, which called for a specified number of lessons without a specification of the dates, were non-cancellable and the student would not be relieved of the obligation to pay the balance due on the contract nor would any refunds be made. At year end, taxpayers analyzed the contracts and brought into income only the amount attributable to lessons actually given, the balance of the contract amounts being deferred until a subsequent year.

The Tax Court, 32 T.C. 1271 (1959), and the Court of Appeals, 296 F.2d 721 (8th Cir. 1961), held that the taxpayer must include in income all contracts entered into during the taxable year. In this Court, however, the Commissioner conceded with respect to accruing amounts that were "neither due as a matter of contract, nor matured by performance of the related services." See 372 U.S. 128, 133 n.6 (1963). On the basis of this concession this Court reversed the part of the judgment below which accrued "amounts for which services had not yet been performed and which were not due and payable. . . ." 372 U.S. at 137.

on deferred and uncollected premiums is not properly includible in the income of a life insurance company for the year past, then clearly the loading at year end is not an asset. Even if considered an asset, it has no cost basis for tax purposes, the required standard of valuation under Code Section 805(b), since it is not includible in income.

The Petitioner here seeks no more than to follow its own books of account, which were found in this respect clearly to reflect income. Petitioner's Annual Statements were prepared in the manner prescribed by the National Association of Insurance Commissioners ("N.A.I.C.") and, as the Amicus argued below, Section 818(a) of the 1959 Act declares that manner of accounting to be the accrual method appropriate for computation of taxes by the life insurance industry.[3] However, even if Section 818(a) of the 1959 Act did not contain a reference to the N.A.I.C. method of ac-

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[3] With respect to deferred and uncollected premiums, the District Court found the N.A.I.C. method to be as follows:

> "The reserve liability of the Plaintiff, as required by law, is determined at the end of the calendar year and this item of reserve is shown on Line 1 of Page 3 of its Annual Statement as a liability. Included in this liability item are the deferred and uncollected net annual valuation premiums for which the Plaintiff has not received an offsetting item of income. The method of accounting prescribed by the National Association of Insurance Commissioners provides for the offsetting of the deferred and uncollected premiums by the inclusion of the deferred and uncollected premiums in the premium income of the plaintiff. Only net deferred and uncollected premiums are needed as offsets for the net annual valuation portion of the premiums included in reserves and the inclusion of the gross deferred and uncollected premiums overstates the premium income of the plaintiff. The Annual Statement required of the plaintiff provides a method of offsetting the overstatement of unreceived income." (Petition, Appendix D, 33a-34a.)

counting, the opinion of the Court of Appeals would deny, to the accrual-method life insurance companies, deferral of income recognition which under the same circumstances would be permitted to other accrual-method taxpayers.

2. Banks and other accrual-basis lenders report interest as income ratably over the period of the loan. The reason for this long-established rule is that interest is earned day by day. (See Banking Law Journal, *Federal Income Taxation of Banks and Other Financial Institutions* (1968) ¶ 5.03(a); see also Prentice-Hall, *Federal Taxes* (1968) ¶ 7215(30), citing S.M. 3820, IV-2 Cum. Bull. 32 (1925) and *Madison & Kedzie State Bank,* 1 B.T.A. 922 (1925).) The holding of the Court of Appeals, if let stand, would accelerate the reporting of insurance company interest income to an earlier period than that required of other financial institutions.

The Court of Appeals held, without explanation, that the capitalized amount of such interest should be included in the valuation of assets. Section 805(b) of the 1959 Act requires insurance company assets, regardless of book value, to be valued at their tax basis. There being no actual cost to the company of unearned interest, as an item which has not been recognized in income following Petitioner's contention, unearned interest must receive a zero basis.

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[4] The holding of the Court of Appeals for the Seventh Circuit as to advance interest on insurance policy loans, which applied a "claim of right" rule to capitalized interest despite a strict obligation to credit interest on repayment, contrasts sharply with the same court's holding as to advance ticket receipts and broadcast revenues by a baseball club with a fixed game schedule. See *Artnell Co.* v. *Commissioner,* 7th Cir., September 19, 1968, 68-2 U.S.T.C. ¶ 9593.

The Importance of Review

The Amicus has circulated among its membership a questionnaire, the results of which are presented in the Petition, clearly showing the litigation-breeding character of the issues in this case. Large aggregate amounts of income—and therefore considerable income tax—are now in doubt for each of the years from 1957 to the present.[5] The issues in this case will produce uncertainty in reporting and auditing for future tax years.

As explained in the Petition, life insurance companies and the IRS have disagreed in their positions on these issues since shortly after passage of the 1959 Act. Litigation of these issues will in all likelihood continue until this Court definitively resolves them. Orderly administration, including the expeditious closing of many tax years now "open" and predictable reporting and payment of taxes for future years, will be assisted by grant of the Writ in this case. The persistence of the IRS and taxpayers in maintaining their respective positions since 1961 makes it clear that no lower forum can settle the issues now raised here.[6]

Conclusion

The Court of Appeals for the Seventh Circuit reached results on both branches of this case which were unwarranted by the 1959 Act. As to both unearned interest and premiums deferred and uncollected, the principles from which the Court departed are, as indicated above, essentially simple ones.

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[5] See Petition 20-28.

[6] See also Petition 26-28, 32-36.

If the decision of the Court below is let stand, the well established and readily followed principles of income accrual and deferral will not be applied to life insurance company taxpayers on the same basis as to other taxpayers. Moreover, there will be included in the assets of life insurance company taxpayers amounts which are not, under those settled principles, to be included in the year-end valuation of assets by the tax-cost standard of the 1959 Act. The importance of these issues to the entire life insurance industry—and the orderly administration of the Federal tax laws applicable to the industry—strongly recommend that this Court take the opportunity to review this case.

For the foregoing reasons, the American Life Convention supports the position of the Petitioner and urges that a Writ of Certiorari be granted.

Respectfully submitted,

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November, 1968

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In the Supreme Court of the United States

OCTOBER TERM, 1968

No. 780

THE FRANKLIN LIFE INSURANCE COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW AND JURISDICTION

The opinion below and the basis of this Court's jurisdiction are adequately described in the petition (pp. 1–2).

QUESTIONS PRESENTED

1. Whether, in determining the income of a life insurance company, the total amount of deferred and uncollected premiums must be included in its "gross amount of premiums" under Section 809(c)(1) of the Internal Revenue Code without the offset petitioner claims for an amount it calls "increase in loading on deferred and uncollected premiums."

2. Whether a life insurance company must include the total amount of deferred and uncollected premiums as assets under Section 805(b)(4) without the adjustment it claims for an amount it calls "loading on deferred and uncollected premiums."

3. Whether a life insurance company, in computing its "taxable investment income," must include the full amount of prepaid interest received during the taxable year and held by the company under claim of right at the end of that taxable year.

4. Whether a life insurance company must include in its assets under Section 805(b)(4) amounts representing unpaid interest that has been capitalized as an addition to the principal amount of such loans.

STATUTE AND REGULATIONS INVOLVED

The relevant provisions of the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959, are adequately set forth in the petition (pp. 3, 51a–78a).

Pertinent provisions of the Treasury Regulations, other than those set forth in the petition (pp. 3, 78a–82a), are reproduced in the appendix to this brief, pp. 24–25, *infra*.

STATEMENT

Petitioner raises four legal issues relating to the determination of a life insurance company's tax liability under the Life Insurance Company Income Tax Act of 1959 (Section 801 through 820, or Part I of Subchapter L, of the Internal Revenue Code of 1954, as amended). The Act provides that the taxable income of a life insurance company includes the full amount

of its "gain from operations" up to the amount of its "taxable investment income," plus one-half of any additional "gain from operations" (Section 802(b)). "Taxable investment income" and "gain from operations" are each the result of detailed calculations and are defined in Sections 804(a) and 809(b), respectively.[1]

In petitioner's timely suit for refund in the United States District Court for the Southern District of Illinois, the court sustained petitioner's contentions in all respects. On the government's appeal, the Seventh Circuit reversed on all issues.

1. DEFERRED AND UNCOLLECTED PREMIUMS

In determining the income tax of a life insurance company, the calculation of "gain from operations" and of "taxable investment income" requires a determination of a life insurance company's "gross amount of premiums" during the taxable year. In calculating "gain from operations," the gross premiums constitute part of the basic figure—*i.e.*, that comparable to "gross receipts" or "gross income"—from which "gain from operations" is computed by subtracting statutorily defined deductions. In determining "taxable investment income," the gross premiums are included in the company's "assets," which control the fraction of investment income that is deemed "taxable".

The "gross annual premium" on a life insurance contract is the consideration the insured pays for a

[1] A description of the calculations performed in computing tax liability under the Act is contained in *United States* v. *Atlas Ins. Co.*, 381 U.S. 233.

year's coverage; each premium covers an annual period beginning on the date of issuance or a subsequent anniversary date. The "net valuation premium" is the part of the "gross annual premium", computed on the basis of State required interest and mortality tables, that must be added to reserves for policyholders in each policy year. The district court defined the difference between the "gross annual premium" and the "net annual valuation premium" as the "loading" (Pet. 31a).[2] It further found that the "loading" does not represent a deduction for anticipated future expenses (Pet. 39a).

Deferred and uncollected premiums are portions of gross annual premiums on policies in force at the end of the taxable year which have not been collected, either because the gross annual premium is being paid in installments over the policy year or the premium is due but unpaid (a grace period having been provided in the policy). (Pet. 32a–33a.) Where payment of part of the premium has been deferred, the premium is increased by an amount designed to compensate petitioner for the loss of interest on the deferred portion of the premium, for the added cost of servicing the account, and for the risk that the insured will die during the policy year while part of the premiums remain deferred and uncollected.[3] If the insured dies at a time when the premium is due but unpaid--i.e., during the grace

[2] "R." references are to appellant's (respondent here) Appendix B in the court of appeals. "Pet." refers to the Petition For A Writ of Certiorari and appendix thereto.

[3] Prior to 1950, unpaid portions of the deferred premiums would be deducted from the policy benefits if the insured died during the policy year (R. 135).

period provided in the policy—the unpaid portion of the premium is deducted from the amounts due the beneficiaries.

Petitioner accrues its reserves on the basis of the assumption that the *full* annual premium is received on the anniversary date of every policy in force, whether or not the full premium has been paid as of that date. (Pet. 40a.) This method of calculating reserves has a three-fold effect in decreasing petitioner's tax base: (1) It increases the reserves which petitioner is entitled to deduct under Section 809(d)(2) in calculating gain from operations; (2) by reason of Section 809(a)(2), it increases the fraction of investment income that is excluded from tax under Section 809(a)(1); and (3) it increases the reserves used in determining the policyholders' share of investment income, which under Section 804(a)(1), is also excluded from tax.

The Treasury Regulations, Sections 1.805–5(a)(4)(ii) (Example 1)[4] and 1.809–4(a)(1)(i),[5]

[4] "Sec. 1.805–5 *Adjusted reserves rate and earnings rates.*

"(a) *In General.* * * *

* * * * *

"(4) *Assets*—* * *

"(ii) *Illustration of principles.* * * *

"*Example* (1). Included in the statement of assets of P, a life insurance company, are the following items: Bonds, stocks, mortgages, home office and branch office buildings owned and wholly occupied by the company, furniture and equipment owned by the company and used in the home office and branch office buildings occupied by the company, agents' debit balances, *premiums deferred and uncollected and premiums due and unpaid*, bank deposits (including time deposits), and share accounts in savings and loan associations." (Emphasis added in Example.)

[5] "Sec. 1.809—4 *Gross amount.*

"(a) *Items taken into account.* For purposes of determining gain or loss from operations under section 809(b) (1) and (2),

expressly require the inclusion of deferred and uncollected portions of premiums in the calculation of both gross premiums and assets. Petitioner does not disagree with this requirement but claims an adjustment—*i.e.*, a deduction or exclusion—for an amount called "loading" in determining its "gross amount of premiums" under Section 809(c)(1) and its "assets" under Section 805(b)(4). Essentially, petitioner would calculate its net valuation premium (*i.e.*, the addition to reserves), subtract that from the gross annual premium, label the remainder "loading", and offset against the gross premiums the part of "loading" petitioner deems allocable to the deferred part of the premium. The end result is to include only the portion of the gross premium that has in fact been paid plus the part of the deferred portion that is included in reserves.[6]

The court of appeals, reversing the district court's approval of petitioner's contentions, refused to (Pet.

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respectively, section 809(c) specifies three categories of items which shall be taken into account. * * * The * * * three * * * items taken into account are: (1) *Premiums.* * * * The term "gross amount of all premiums" means the premiums and other consideration provided in the insurance or annuity contract. * * * *Such term includes advance premiums, premiums deferred and uncollected and premiums due and unpaid*, * * *." (Emphasis added in last sentence.)

[6] Petitioner follows the treatment provided on the annual statement form of the National Association of Insurance Commissioners, which petitioner must file annually in the States where it does business. (R. 75, 177–178, 321–324, 328–334). The annual state-

8a–9a) "attribute to Congress an intention that in the same statutory equations, exclusions and deductions attributable to reserves are to be based on the assumption that the annual premium is fully paid up and yet the amounts in the same equation from which these figures are to be subtracted are to be determined on the assumption that the annual premium is not fully paid up." It concluded that (*id.*, 9a) "The gearing of the tax statute to an annual reserve requires recognition of no less than the annual premium."

2. INTEREST COLLECTED IN ADVANCE AND CAPITALIZED INTEREST

All of petitioner's life insurance policies and annuity contracts having cash values provide that a loan may be obtained on the sole security of the policy whenever a cash value is available and the policy is in force. Interest on policy loans is payable in advance. At the time the loan is made, the interest to the end of the current policy year is deducted from the principal loaned to the policyholder, and a year's interest is due annually thereafter on each policy anniversary date. If an ensuing year's

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ment form is intended to demonstrate the solvency of the company using purposefully stringent and conservative accounting standards, designed to show an assumed net worth upon liquidation of the company (R. 177–178, 328–330, 334; Pet. 5a, 9a.) Although petitioner relied upon the NAIC form below, and the petition is replete with references to the form, petitioner apparently no longer contends that the NAIC form is binding for Federal tax purposes.

interest is not prepaid on that date, and the available cash value equals or exceeds the unpaid interest, the latter is "capitalized"—*i.e.*, it is added to principal to the extent of the remaining cash value. (R. 88.)

Although there is no due date for repayment of the loans, policy loans may be repaid in whole or in part at any time. Upon such a repayment during the policy year, a pro rata portion of the interest is refunded. If the borrower surrenders his policy for the remaining cash value or dies during the year, only that ratable portion of the interest considered "earned" is retained—the remainder is repaid to the borrower or his beneficiary. (R. 88.)

The district court rejected the government's position that prepaid interest must be taken into investment income when received and unpaid interest added to assets when capitalized. Instead, it agreed with petitioner's claim that it need reflect as income only that portion of the prepaid interest which it describes as ratably "earned" during the tax year and that it similarly need include in assets only what it describes as the ratably "earned" amount of capitalized unpaid interest.[7] The court of appeals reversed, first because the prepaid interest was received and held without any restriction on its use, and also because the government's position was considered to be a proper exercise by the Commissioner of Internal Revenue of his authority to require that methods of

[7] Petitioner (Pet. 13a) introduced no evidence as to the amount, if any, of refunds of prepaid interest it was required to make from year to year; it only estimated the "unearned" interest for four of the taxable years involved (R. 270–271, 274, 284–285).

tax accounting "clearly reflect income" (26 U.S.C. 446 (b)) (Pet. 12a–13a).

ARGUMENT

1. DEFERRED AND UNCOLLECTED PREMIUMS

(a) Contrary to the impression that petitioner and the *amicus curiae* each attempt to give, they neither rely on nor wish to have applied what they call (Pet. 13) "settled principles of tax accrual accounting". Indeed, it is quite clear that they would strenuously object to an across the board application of their concept of accrual principles. The basis for petitioner's argument that the deferred and uncollected premiums should not be reflected in its tax base is its claim that it has no right to compel payment of these portions of the gross premium. But if that were to be the keystone to accounting under the 1959 Act, the amount of reserves an insurance company could claim would then be reduced by the amount of reserves attributable to deferred and uncollected premiums,[8] thereby increasing gain from operations and the taxable investment income. This is an outcome that petitioner in fact opposed in its brief below (at pp. 57–58).[9]

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[8] Thus the Treasury Regulations require "appropriate reduction * * * in the life insurance reserves" if "it is determined on the basis of the facts of a particular case that premiums deferred and uncollected and premiums due and unpaid are not properly accruable for the taxable year". Treas. Reg. Section 1.801–4(f).

[9] The record does not show the net effect on petitioner's tax liability of decreasing both its reserves and its gross premiums by the amount allocable to deferred uncollected premiums unpaid at the end of each taxable year in issue here.

The proper way to approach the treatment of deferred and uncollected premiums is to determine first what Congress meant in its reference to "the gross amount of premiums" in Section 809(c)(1). Although the statute does not further define this phrase, Congress, as the court of appeals recognized, was fully familiar with the accounting practices used in the insurance industry and it must therefore be assumed that Congress was aware that life insurance companies, in accounting for their gross premiums, accrue the full year's premium as of the anniversary date of each policy.[10] The only logical inference is that Congress thought the same assumption would be made in defining the phrase "gross amount of premiums" it used in the statute.

Indeed, we do not understand the petitioner or the *amicus* to argue otherwise. Rather in its court of appeals brief petitioner expressly stated (p. 44) "the intent and purpose of the Life Insurance Company Income Tax Act of 1959 require that the deferred and uncollected premiums be included in income on a gross basis (which includes loading)—and that is what this regulation provides." Thus, petitioner includes the deferred portion of premiums in its "gross" but then claims an "offset"—in substance an exclusion or a deduction—for so much of the deferred and uncollected premiums as exceed the part of such premiums it seeks to use—as "reserves"—to decrease its tax liability.

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[10] Petitioner's witnesses referred to this accrual as being based on a "fictional" assumption. (R. 132.)

The initial defect in this contention is that Congress has not provided for such an exemption or deduction. Although subchapter L of the code is filled with detailed provisions which define a number of allowable exclusions and deductions in the computation of the income tax liabilities of life insurance companies, not one refers, directly or indirectly, to "loading" or "increase in loading." It is no less true here than in any other tax case that exclusions and deductions must have an explicit statutory basis, and, as the court of appeals recognized here (Pet. 7a), the absence of such a statutory provision is fatal to petitioner's claim.

The second defect is found in petitioner's repeated attempts to give the impression that the offset it claims is but a reflection of items, like agents' commissions, that in any event would later become deductible. The district court expressly found, pursuant to petitioner's request, that the sought-for "loading" deduction did not represent estimates of anticipated expenses. Moreover, as Congress was fully aware, see S. Rep., No. 291, 86th Cong., 1st Sess., pp. 6–7, "loading" also includes whatever profits petitioner might realize from the particular gross premium.

Indeed the effect of petitioner's claimed offset would be to defer tax indefinitely on part of its first year's profit on policies having deferred premiums. In the first policy year petitioner would take deductions for all expenses incurred during the taxable year, a full year's reserve on the policy, and the loading deduction claimed here. In later taxable years, the first year's loading deduction would not be recovered into income, for loading on the deferred and uncollected

portion of the premium would remain constant and petitioner would deduct expenses in fact incurred in succeeding years. "The only point at which the additional deduction would be recovered for tax purposes would be in the last year of the policy, or in the event the terms were changed so as to provide for no more deferred payments; * * *. [I]n the case of a stable or growing company, such overall deductions would not be recovered for tax purposes * * * until some indefinite time in the future." *Jefferson Standard Life Ins. Co.* v. *United States,* 272 F. Supp. 97, 115 (M.D.N.C.), appeal pending (C.A. 4).

The defects in petitioner's position are even more apparent with respect to the determination of its assets than in the case of its "gain from operations." It is an elementary principle of accrual accounting that assets and liabilities must be related in point of time. (R. 333) For example, it is established that a taxpayer who accrues the cost of goods sold must also accrue in his income the full amount of the receivables attributable to the sales even if payment has in fact not been made. See *Charles C. Lewis Co.* v. *United States,* 14 F. Supp. 471 (D. Mass.). Here, contrary to that rule, petitioner would accrue as a liability the full annual reserve for insurance coverage but then not show as an asset the full amount of the annual premium which gives rise to the liability.

The only support for petitioner's claim is that the treatment urged is allowed for NAIC annual statement purposes. That form, however, was designed to show the financial strength of a life insurance company using stringent and purposefully conservative

standards for the purpose of demonstrating the company's strength upon liquidation. That purpose requires a minimization of income and assets, an objective entirely alien to the function of the income tax laws.[11]

Furthermore, the NAIC approach, in line with its basic objective, shows the greatest possible liabilities on the reserve side, while reflecting only the amount of deferred and uncollected premiums equal to the reserves included with respect to those premiums. This case, however, is concerned with a tax formula which relies upon the proportionate relationship between assets and reserves in determining the amount of investment income that is to be excluded from petitioner's tax base. For these purposes, as the court of appeals said (Pet. 9a), petitioner cannot use "an admittedly overstated reserve while at the same time allowing an accounting entry with respect to assets which, while compensating *numerically* for the overstatement, does not fully account for the related asset * * *." (Emphasis original.)

Nor can the reference in Section 818(a) of the Code to the NAIC form provide the blanket adoption of NAIC accounting necessary to sustain petitioner's claim. The comprehensive detailed tax formulae set

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[11] The life insurance industry's own Joint Committee on Blanks of the American Life Convention and the Life Insurance Association of America agreed in 1963 that the basic objectives of the annual statement are so different in concept as to preclude the revision of the annual statement blank to conform to tax accounting concepts. (R. 329–330.) II Proceedings of the National Association of Insurance Commissioners (1963), pp. 445–447.

out in the substantive sections of Subchapter L belie any assumption that Congress merely sought to adopt the NAIC form *in toto* into the taxing statute.

Moreover, the legislative history of the Act makes clear that the NAIC form may only be used when "not inconsistent with the provision of the 1954 Code and an accrual method of accounting." H. Rep. No. 34, 86th Cong., 1st Sess., p. 42. Not only does Subchapter L fail to provide a deduction or exclusion with respect to loading, but such an adjustment would indefinitely defer tax on part of petitioner's income and would allow deductions for expenses that have not been incurred. And petitioner's method may not properly be called an accrual method of accounting, for it would accrue the deferred and uncollected premiums for purposes of determining deductible and excludable reserves, but would not allow the accrual for the rest of the equation that determines petitioner's overall tax situation.[12]

(b) Petitioner cannot seriously argue (Pet. 13–14), as it has attempted only since the decision below,

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[12] Although petitioner and the *amicus* attack our position as an attempt to include in income amounts that petitioner has no right to receive or may never receive, the record shows that petitioner receives 95 to 98% of the deferred and uncollected permiums in the regular course. (R. 334) In the remainder of situations, petitioner is equally well covered. When the premium is overdue and unpaid, petitioner either cancels the policy, or, if death occurs during the grace period, deducts the unpaid premium from the policy benefits. When payment of the premium has been deferred to a semi-annual, quarterly, or monthly basis, petitioner receives a premium larger than the annual premium, and the addition, *inter alia*, covers the risk that the policyholder will die before completing payments on that year's premium (see pp. 4–5 *supra*).

that constitutional limits on the income tax power require the offset it claims. This Court has on a number of occasions made clear that Congress constitutionally may require the recognition of certain items of income as a condition for the allowance of deductions conferred as a matter of legislative grace. For example, in *Helvering* v. *Independent Life Ins. Co.*, 292 U.S. 371, a life insurance company was required to include in gross income the net rental value of that portion of a building which it occupied as a condition to taking depreciation and other income tax deductions on the entire building.

More recently, in *United States* v. *Atlas Ins. Co.*, 381 U.S. 233, this Court rejected a claim that a life insurance company's tax exempt interest (as from municipal bonds) should be attributed in its entirety to the taxable rather than nontaxable portions of the company's income; the rationale of the taxpayer's argument was that an allocation of the tax exempt items would indirectly tax income that is statutorily exempt. See 381 U.S. at 236–239. Citing *Helvering* v. *Independent Life Ins. Co., supra,* the Court took the opportunity to "affirm the principle * * * that the tax laws may require tax-exempt income to pay its own way" and to state its view that "Congress has done no more * * * than to particularize this principle in connection with taxing the income of life insurance companies." (381 U.S. at 247.)

Here petitioner and the industry generally are content to compute reserves and reduce tax liabilities on the basis of an accrual of the full premium

on every policy as of the anniversary date. No constitutional barrier prevents the requirement that the same accrual control the statutorily required additions to income.

(c) The decision of the court of appeals in this case is the first appellate test of the deferred and uncollected premium issues, and the only other district court to pass upon the issues also agreed with the government's contentions, *Jefferson Standard Life Insurance Co. v. United States, supra*.[11] Accordingly there is no conflict of judicial decision which independently justifies a grant of certiorari.

To be sure, petitioner asserts (Pet. 19) a "flat conflict" with the decision of the Tax Court in *Western National Life Ins. Co. v. Commissioner*, 50 T.C. No. 28. But petitioner has neglected to add that the case does not support its position here and in fact remains open on the Commissioner's petition for reconsideration. The initial holding in *Western National* was that deferred and uncollected premiums are to be excluded entirely from the Section 805 computation of assets—the position that petitioner expressly disclaimed below and a conclusion that would require a reduction in the allowable reserves (Tr. 70–71).[12] After the Commissioner moved for reconsideration on May 31, 1968, maintaining the position taken by the government in this case, the Tax Court invited the *amicus* here to submit a brief setting forth the industry position. In that brief and in the argument before the

[11] This case is on appeal to the Fourth Circuit, and was argued and submitted on October 30, 1968.

[12] See p. 10, *supra*.

Tax Court on August 7, 1968, the amicus asserted that the decision was wrong and that the Tax Court should adopt the position petitioner takes here."

Although we believe that petitioner has grossly exaggerated the revenue consequences of the decision below,[11] we agree that it is an industry-wide issue and has significant monetary importance.[12] We would therefore not oppose certiorari even in the absence of

[11] As of this writing no decision or other action has been taken, and the Commissioner's motion remains pending after oral argument.

[12] Illustrative of petitioner's method for demonstrating that "the figures are of staggering size", the loading on deferred and uncollected premiums as of December 31, 1960, is estimated to be $850,000,000. (Pet. 23.) But this figure affects only the assets, and it is a rather small part of all life insurance assets. The assets total is used only in the determination of a "current earnings rate" under Section 805(b)(2), which then becomes one of the determining factors in computing the excluded "policyholder's share" of taxable investment income.

[13] Best available Treasury estimates are that the current deferred and uncollected premium issues involve approximately $9,000,000 annually and that the total amount involved for the eleven year period 1958–1968 approximates $70,000,000. This estimate was obtained by computing the increase in tax attributable to the deferred and uncollected premium issues for the ten largest life insurance companies (seven mutuals and three stock companies) for the period 1958–1963. The average tax increase of 9% was then projected through estimated taxable income of the entire industry for the period 1958–1968. The Treasury's computation in *United States* v. *Atlas Ins. Co.*, *supra*, where the petition was granted in the absence of conflict upon a showing that at least a "quasi-constitutional" issue was presented, showed that 8,000 claims involving $100,000,000 were then at stake, and that the estimated annual projection of the revenue involved for future years ranged from $77,000,000 to $325,000,000. (Petition for a Writ of Certiorari, No. 189, October Term, 1964, pp. 15–17.)

a conflict if it appeared that present review would facilitate the final settlement of the income tax liabilities of this and other life insurance companies. But review would not dispose of those cases, since they involve other important questions of statutory construction—most of them industry-wide issues involving substantial amounts—as well as the deferred and uncollected premiums issue." In addition, a grant of certiorari here well might freeze those cases in their present status and further postpone the date on which audits of the life insurance companies may be closed.

Here, moreover, petitioner expressly disclaimed in the lower courts an issue that it seems to argue in its petition—the claim that accrual principles require the full exclusion of deferred and uncollected premiums from the income tax computation. And the finding that the "loading" that is the keystone of the sought-for offset does not even represent an estimate of anticipated expenses suggests that review on this record would be particularly inappropriate.

" For example, the appeal and cross-appeal of *Jefferson Standard Life Ins. Co. v. United States*, *supra*, argued and submitted to the Fourth Circuit on October 30, 1968, involves not only three of the four issues here but seven other issues of first impression under the 1959 Act. Similarly, *Occidental Life Insurance Co. of California* v. *United States* (C.D. Calif., Civ. No. 66-273 F) involves not only the deferred and uncollected premium issues but also four other issues of first impression. *Western National Life Ins. Co.* v. *Commissioner*, 50 T.C. No. 28, *supra*, still open on the Commissioner's motion for reconsideration, involves at least two other important issues besides deferred and uncollected premium issues.

2. PREPAID AND CAPITALIZED INTEREST

(a) Petitioner requires borrowers to prepay a year's interest on loans made against the cash value of the policies. If the advance interest has not been paid on the anniversary date of the policy, and the available cash value exceeds the unpaid interest, petitioner capitalizes that interest by adding it to the principal of the policy loan.

Although a ratable refund of prepaid interest is made if part or all of the principal is repaid during the policy year, the loans have no due date and petitioner has no fixed or even predictable future liability to repay the prepaid interest. Thus the interest which petitioner collects in advance belongs to it with no restriction whatsoever as to its use, and, under settled principles, those amounts must be included in taxable investment income. For an accrual basis taxpayer must report in full amounts actually received by it under a claim of right during the taxable year, and this is so even when portions of those amounts represent payment for services rendered in a subsequent year (*Schlude* v. *Commissioner*, 372 U.S. 128) and despite the fact that taxpayer later may be required to refund some of the money (*North American Oil* v. *Burnet*, 286 U.S. 417).

Similarly, there is no reason to omit any part of the capitalized interest in computing the "assets" of petitioner. These amounts earn additional interest for petitioner throughout the taxable year, just as does

the principal amount of any loan petitioner has made. When these amounts are added to the loan principal, they reduce the amount petitioner would pay the insured upon either death or surrender of the policy. Since the transaction thereby reduces the liability side of petitioner's ledger, the result is the same as though the borrower had paid the interest in cash. The fact that some part of that interest might have to be returned if the borrower pays up the loan in the following year is immaterial in the case of an accrual basis taxpayer for the reasons already discussed in respect to interest collected in advance. Significantly, even the NAIC annual statement form (on which petitioner seeks to rely in connection with other issues) requires that the entire amount of interest capitalized during the year be reflected as assets of the life insurance companies. (R. 293–294, 296.)"

(b) As in the case of the issues relating to deferred and uncollected premiums, the court of appeals decision here is the first appellate expression on point.[19] Again, the only other district court to pass upon these issues reached the identical result, *Jefferson Standard Life Ins. Co. v. United States, supra.*

There is not, as petitioner urges (Pet. 32), an intra-circuit conflict between the decision here and the de-

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[18] Although petitioner maintains that its position is consistent with the NAIC forms in respect to both prepaid interest and capitalized interest (Pet. 11), its explanation of why that is so is limited to description of the Exhibits to the form relating to income only—the schedule of assets is not discussed (Pet. 11 n. 2).

[19] The opinion is in accord with Rev. Rul. 58-225, 1958-1 Cum. Bull. 258.

vision in *Artnell Co.* v. *Commissioner*, 400 F. 2d 981 (C.A. 7). *Artnell* arose because a corporate reorganization and liquidation terminated the taxable year of the Chicago White Sox baseball team. The issue was whether the liquidated corporation should be required to report sales of tickets and other prepaid revenues related to future games when the later games were to be played by the successor corporation. Petitioner entirely fails to recognize that the Seventh Circuit did *not* hold that deferral of the prepaid income was proper. It merely remanded for further inquiry into the question whether (*id.*, 984) "the extent and time of future performance are so certain, and related items properly accounted for with such clarity, that a system of accounting involving deferral of prepaid income is found clearly to reflect income * * *". And this result must be viewed in the light of the peculiar fact that holders of tickets to unplayed games could secure refunds merely by demand.

In our view, *Artnell* was wrongly decided and reflects an improvident reading of the Commissioner's authority to determine whether a method of accounting clearly reflects income. See 26 U.S.C. 446; compare *Schlude* v. *Commissioner*, *supra*; *American Automobile Ass'n.* v. *United States*, 367 U.S. 687. There is not, however, a conflict, for there are multiple bases on which the two cases may be distinguished. For example, this case does not involve dual taxpayers or a pretermitted taxable year, and the contingencies that might cause restoration of the prepaid amounts are substantially different in nature.

The rule of *Artwell* will indeed not be entirely clear until the court of appeals has a further opportunity to consider the *Nebbia* rule in the light of whatever evidence is adduced upon remand to the Tax Court. Thus, it is particularly noteworthy that the *Artwell* opinion does not even refer to the opinion here."

(c) Although petitioner cites seemingly large dollar figures as the amounts of interest at issue on an industry-wide basis, it entirely neglects to translate its data into tax consequences. Assuming, for the moment, the accuracy of petitioner's claim (Pet. 35) that $35,000,000 in interest is involved, that gross amount must be reduced first to reflect the excluded "policyholder's share" (usually 75 per cent or more) of taxable investment income and then multiplied by the effective corporate income tax rate. The tax result would be less than 48 per cent of less than 25 per cent of $35,000,000—around $4,000,000 annually. There is, moreover, another inflationary element in petitioner's

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[1] There is no substance to the claim (Pet. 30-31) that the decision here is inconsistent with *Gunderson Bros. Engineering Corp.* v. *Commissioner*, 42 T.C. 419, and *Lukens Motor Co.* v. *Commissioner*, 42 T.C. 732. As the court below observed (Pet. 13a) those cases "did not involve amounts actually received by the taxpayers by way of prepayment."

There is a similar defect in petitioner's claim of a "completely baseless discrimination" between banks and life insurance companies (Pet. 36). Notably the only Internal Revenue Service publication relied on (Pet. 31 n.1), S.M. 3820, IV-2 Cum. Bull. 32 (1925), did not deal with interest actually received but with interest which was not to be received by the bank until the maturity of the notes in later years. Thus, it was not a situation, such as here, where the lender had the interest in hand, through either prepayment or as a charge against the cash value of an insurance policy which it already held.

estimate. Its source is NAIC Form, Exhibit 3, line 5, column 7, which includes "interest on premium notes, policy loans and liens" (Pet. 35, fn. 5), and petitioner has made no effort to sift out the interest on policy loans from that total."

In the final analysis, the interest issues are unworthy of further review in the absence of a conflict.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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FEBRUARY 1969.

"A Treasury analysis of the returns of the ten largest life insurance companies (seven mutuals and three stock companies), which account for 55 percent to 60 percent of the total income taxes paid by the life insurance industry, discloses that four have adopted the practice of banks making loans to depositors and do not collect interest in advance on policy loans. (See p. 22, n. 21, *supra*.) The total amount of prepaid interest was less than $2,000,000 for the entire period 1958–1965, most of which was accounted for by two companies. The tax consequences are even less, since the $2,000,000 must be broken down into annual figures, the greater part excluded as the "policyholders' share" of investment income, and the 48 percent tax rate applied against the balance.

APPENDIX

Treasury Regulations on Income Tax (1954 Code):

Sec. 1.801–4. *Life insurance reserves.*

* * *

(f) ***Adjustments to life insurance reserves.*** In the event it is determined on the basis of the facts of a particular case that premiums deferred and uncollected and premiums due and unpaid are not properly accruable for the taxable year under section 809 and, accordingly, are not properly includible under assets (as defined in section 805(b)(4) for the taxable year, appropriate reduction shall be made in the life insurance reserves. This reduction shall be made when the insurance company has calculated life insurance reserves on the assumption that the premiums on all policies are paid annually or that all premiums due on or prior to the date of the annual statement have been paid.

(26 C.F.R. 1.801–4.)

* * * * *

Sec. 1.805–5. *Adjusted reserves rate and earnings rates.*

(a) ***In general.*** * * *

* * * * *

(4) ***Assets***—(i) ***Definition.*** Section 805(b)(4) defines the term "assets" as meaning all assets of the life insurance company (including nonadmitted assets), other than real and personal property (excluding money) used by the life insurance company in carrying on an insurance trade or business. * * *

* * * * *

Example (1). Included in the statement of assets of P, a life insurance company, are the following items: Bonds, stocks, mortgages, home office and branch office buildings owned and wholly occupied by the company, furniture and equipment owned by the company and used in the home office and branch office buildings occupied by the company, agents' debit balances, premiums deferred uncollected and premiums due and unpaid, bank deposits (including time deposits), and share accounts in savings and loan associations. For purposes of section 805(b)(4) and this subparagraph, the home office and branch office buildings owned and wholly occupied by the company, and the furniture and equipment owned by the company and used by it in connection with the operations conducted in the home office and branch office buildings occupied by the company, shall be excluded from the term "assets" since such items are the only ones considered as being used by P in carrying on an insurance trade or business. Accordingly, since bonds, stocks, mortgages, agents' debit balances, premiums deferred and uncollected and premiums due and unpaid, bank deposits (including time deposits), and share accounts in savings and loan associations are not considered as being used by P in carrying on an insurance trade or business, they are included within the term "assets" and, therefore, shall be taken into account by P in determining its current earnings rate.

* * * * *

(26 C.F.R. 1805–5.)

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1968

No. 780

THE FRANKLIN LIFE INSURANCE COMPANY,

Petitioner,

—v.—

UNITED STATES OF AMERICA,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

REPLY BRIEF FOR PETITIONER

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I. *The Issues Respecting Premiums Deferred and Uncollected*

The Government does not deny:

1. That under any conventional test for the accrual of income, the "deferred and uncollected" premiums—which are not received or receivable—would not be included in income. —Rather, the Government appears to say that the "deferred and uncollected" premiums are not accruable under conventional tests, but because of certain deductions which the petitioner is allegedly taking it is only appropriate that the deferred and uncollected premiums be reflected in income even though conventionally they would not be (Br. Op. 9-10);

2. That the issues as to whether such amounts should be reflected in income and whether the loading on the

deferred and uncollected premiums should increase the assets of life insurance companies are issues which affect virtually all life insurance company taxpayers; that these are "industry-wide" issues under the Life Insurance Company Income Tax Act of 1959 (the "Act"); and that there is a mounting tide of litigation upon these issues (Pet. 24-27; Br. Op. 17);

3. That it is the general rule, rather than the exception, that all eleven taxable years which have been experienced commencing in 1958 under the Act are "open" for life insurance company taxpayers and involve these issues (Pet. 24-29; Br. Op. 17 n. 17); and

4. That even by the Government's own calculations—which contain a misuse of statistical method tending substantially to understate the amounts involved—there is some Seventy Million Dollars ($70,000,000) in back Federal income taxes which are dependent upon the resolution of these issues. (Br. Op. 17 n. 17)

Nonetheless, the Government opposes the grant of certiorari on these issues for a number of reasons, all of which are manifestly insubstantial:

1. On the merits, the Government appears at least in part to abandon the theory on which it managed to prevail in the Court of Appeals. —That theory was, in essence, that the position which petitioner contended for amounted to an attempt to take a deduction not provided for by law. Instead, the Government postulates a suspiciously new theory on which the judgment of the Court of Appeals might be sustained.

The new theory is apparently that because petitioner is allegedly permitted to take certain extraordinary de-

ductions, Congress has conditioned the taking of those deductions on the inclusion in petitioner's income of amounts not otherwise includible—the gross amount of premiums deferred and uncollected. Thus, the Government now argues "that Congress constitutionally may require the recognition of certain items of income as a condition for the allowance of deductions conferred as a matter of legislative grace." (Br. Op. 15)

But even if one were to grant, for the sake of argument, that Congress has the power to follow such an extraordinary course and to include the items in question in income, there is no evidence that it meant to do so here:

(a) In the first place, the statute is totally silent on the subject of including premiums deferred and uncollected in income. Had Congress decided to include these amounts in income, as part of the price for an unusually gracious allowance of a deduction, one would have thought that it would have left some hint in the statute that it was doing so. There is none. It is only when one reads the Treasury Regulations' crude rewriting of the statute (see Pet. 15) that one finds any reference to premiums deferred and uncollected. The Government's argument that the statute must have meant to include these fictional amounts—despite the silence of the statutory text and of the legislative history on this subject—is founded upon conclusionary phrases to the effect that "it must therefore be assumed that Congress was aware"[1] and to the effect that "the only logical in-

[1] What the Government hypothesizes that "Congress must have been aware" of is the "accounting practices used in the insurance industry" allegedly that the companies "accrue the full year's premium as of the anniversary date of each policy." (Br. Op. 10) However, if Congress was aware of this, it was also aware of the fact that under the industry's accounting practices, these assumptions do not enter into the calculation of gain from operations, because they are "wrung out" by the methods which we describe in the Petition for Certiorari. (Pet. 7-9)

ference is that Congress thought" that certain "assumptions" would be made in defining what "gross amount of premiums" meant when it used it in the statute. (Br. Op. 10) —It is, we submit, insupportable to infer that Congress exercised some power to require amounts not otherwise statutorily includible in income—or perhaps not even within the constitutional definition of income (Br. Op. 14-16)—to be included in income as a condition upon the taking of deductions, merely on the basis of *sub silentio* action.

(b) Moreover, the fact is that there are no extraordinary deductions upon the taking of which Congress might have conditioned the inclusion of these amounts in income. As we demonstrated in the Petition (pp. 7-9, and n. 9, p. 7), there are no "deductions" at all involved in the position we contend for. The net result of the computations which petitioner goes through in figuring its income on the NAIC form is that premiums deferred and uncollected are not reflected in income at all and no deduction whatsoever is effectively taken for the reserves applicable to the premiums deferred and uncollected.

The Government's keystone position on the inclusion of premiums deferred and uncollected in gain from operations turns on a plain misstatement of fact. The Government states that if the loading on premiums deferred and uncollected was not includible in income, there should also not be reflected in income the deduction for the increase in reserves attributable to the premiums deferred and uncollected. The Government suggests that the life insurance companies would not like this because it would increase the amount of their gain from operations. (Br. Op. 9)

The fact of the matter is, however, as we laboriously pointed out in the Petition (Pet. 7-9), that the effect of the calculations which petitioner goes through in computing its gain from operations is to put it in exactly the same position as if it had neither accrued any premiums deferred and uncollected or any of the related reserves.[2] As we pointed out in the Petition, the computations which petitioner is required to go through under the NAIC form in computing its gain from operations "match" the gross premium deferred and uncollected against the "loading" on it and the reserves in respect of it. By definition, the re-

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[2] The Government has furnished a clear indication of the precise nature of its fallacy. It states: "Indeed the effect of petitioner's claimed offset would be to defer tax indefinitely on part of its first year's profit on policies having deferred premiums. In the first policy year petitioner would take deductions for [1] all expenses incurred during the taxable year, [2] a full year's reserve on the policy, and [3] the loading deduction claimed here." (Br. Op. 11)— But all that petitioner wants to do in fact is to take deductions for the expenses actually incurred and the reserves attributable to premiums actually received, and to take into income the premiums actually received.

The Government is guilty of a misstatement when it claims that petitioner is really trying to take a deduction for alleged item (2)—"a full year's reserve on the policy." Petitioner does not take a deduction for a full year's reserve on the policy because, to the extent that the reserve is in respect of premiums deferred and uncollected, under the NAIC form petitioner "wrings" out of the income statement these reserve liabilities by including an offsetting factor against them—the net valuation premium on the premiums deferred and collected (Pet. 7). Nor does petitioner take a deduction for item (3); petitioner has not received the loading nor has it any right to receive it; it simply does not include the loading in income. The horror suggested in the rest of this paragraph of the Government's brief, that petitioner is contending for an indefinite deferral of income, can, accordingly, be dismissed. All that happens under petitioner's method of keeping its accounts—which accords in result, with respect to gain from operations, with settled principles of tax-accrual accounting—is that it does not reflect in income ("gain from operations") the premiums and the related reserve liabilities until the premiums are actually received or there is a right to receive them.

serves and the loading together make up the gross amount of the premiums deferred and uncollected. The computations, by wringing out all three items—the gross premiums deferred and uncollected on the one side of the equation, and the components thereof, the reserves and the loading on the other, put petitioner's gain from operations on precisely the same footing as if the premiums deferred and uncollected had never entered into the computation at all. (See n. 6, pp. 9-10, *infra*.) As the Government appears to admit, this is precisely the result that would be obtained under "settled principles of tax accrual accounting."

The truth of the matter is that it is the Government, not the taxpayer, which is seeking to give effect, in the computation of gain from operations, to premiums deferred and uncollected. The petitioner's position is, and always has been, that these amounts and the related reserve increases should not be reflected by way of income or deduction in the computation of gain from operations.[3] Under petitioner's calculations, they are not reflected at all—positively or negatively—in that computation. —With respect to the computation of petitioner's assets (used for certain calculations under the Act, see Pet. 4 and n. 3), petitioner again simply follows the NAIC form—as it must under state law—which, to be sure, here takes into account reserve liabilities with respect to the premiums deferred and

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[3] The Government suggests that petitioner admitted in its brief in the Court of Appeals that the effect of the NAIC computations of gain from operations was different from that which would prevail under conventional principles of tax-accrual accounting, under which neither the reserves with respect to premiums deferred and uncollected nor the premiums deferred and uncollected would be taken into account. (Br. Op. 10) The pages cited by the Government may be searched in vain for any such concession, and petitioner of course has made none.

uncollected,[4] but which introduces an asset on the other side of the balance sheet—the premiums deferred and uncollected, net of loading—which exactly matches this liability. The extra amount the Government would add never appears in this NAIC-dictated computation at all. The Government would add this amount as an asset through pure fiat. The Government says that the reason why the NAIC form does not include the loading with respect to premiums deferred and uncollected is because that form is excessively concerned with solvency. See Br. Op. n. 6, pp. 6-7, pp. 12-13. But it is hardly excessively conservative for the NAIC form not to treat as an asset the loading on premiums deferred and uncollected amounts which, as of the balance sheet date, petitioner has not received and has no right to receive.

We know of no system of accounting that takes the apparent view of the Government that because these amounts are likely, someday, mostly, to be received they should be treated as an asset even though they are not received or receivable. The sole authority cited by the Government

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[4] Since these reserves are "required by law," the taxpayer must take them into account in the asset computations provided for the computation of its "taxable investment income." See §§ 801 (b)(2) and 804 of the Act.

The Government misstates the terms of the statute by stating (Br. Op. 3) that in "determining 'taxable investment income', the gross premiums are included in the company's 'assets', which control the fraction of investment income that is deemed 'taxable'."— The fact of the matter is that the statute never provides that gross premiums, or any kind of premiums, are to be considered "assets." See the provision as to assets, Section 805(b)(4) of the Act, Pet. App. 63a. In fact, the statutory provision does not substantially redefine the term "assets." It is hard to argue, as the Government must, from this "thin" statutory definition that the loading on premiums deferred and uncollected, amounts which the company has neither a right to receive nor has received, and which do not appear on its balance sheet, are to be considered "assets."

is a case which holds that accounts which had become receivable as of a year-end have to be taken into account by an accrual-basis taxpayer. *Charles C. Lewis Co.* v. *United States,* 14 F. Supp. 471, 473-74 (D. Mass. 1936). (Br. Op. 12) No one can quarrel with this elementary principle; the point is that the premiums deferred and uncollected here involved are by definition neither received nor receivable. As the Government itself observes (Br. Op. 3): "In calculating 'gain from operations,' the gross premiums constitute part of the basic figure—*i.e.*, that comparable to 'gross receipts' or 'gross income'—from which 'gain from operations' is computed by subtracting statutorily defined deductions." But the short of our position is that when Congress used "gross premiums" in the statute, it meant it in the same sense as "gross receipts" or "gross income"—that is, the total amount received or receivable during the taxable year.[5]

2. Alternatively, the Government harkens back to the tactic which prevailed in the Court of Appeals, and misstates our position by claiming that we admit the inclusion of the amounts in question in income but then seek a deduction for the loading on the premiums deferred and uncollected on the ground that it is a proper estimate of future expenses. (Br. Op. 10-11) The Government then quite properly makes the point that there is no exact correlation between the "loading" on premiums deferred

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[5] Indeed, the Senate committee which reported on the Act indicated that the computation of gain from operations began with gross *receipts* and observed:

> "Gross receipts.— The first step is to determine *gross receipts. Gross receipts* for this purpose include *premiums and other considerations on insurance* and annuity contracts and also considerations for supplementary contracts." S. Rep. No. 291, 86 Cong., 1st Sess. (1959), 2 U.S. Code Cong. & Ad. News, at p. 1595 (emphasis supplied).

and uncollected and the ultimate expense and profit components that will be experienced when, as, and if the premiums in question are received. (Br. Op. 11)

The Government states that petitioner has made "repeated attempts to give the impression that the offset [*sic* —what is meant is the noninclusion of the premiums deferred and uncollected in income] it claims is but a reflection of items, like agents' commissions, that in any event would later become deductible." (Br. Op. 11) This may be an argument which the Government would have preferred that we had made, but we have not made it. The Government does not proffer any citation to the place in which we have made this argument; indeed, the District Court, at petitioner's request, found that the "loading" did not constitute an estimate of future expenses. (Pet. 39a)

The truth of the matter is that we are not claiming a deduction for future expenses at all, or, indeed, claiming any deduction with respect to the loading.[6] Our basic

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[6] What the "loading" "exactly balances," as we pointed out in the Petition, is not the anticipated future expenses—there is no necessary correlation between the loading and the anticipated future expenses—but the difference between the gross amount of premiums deferred and uncollected and the net valuation premium deferred and uncollected. (Pet. 7) Indeed, the District Court so found, and the Government's Brief in Opposition appears to accept this finding (Br. Op. 4); in fact, this is true by definition. (Pet. 7-8, n. 9) Since the net valuation premium deferred and uncollected and the loading thereon together exactly equal the gross premium deferred and uncollected, the effect of the three-stage calculation—(1) subtracting the increase in the net valuation premium (which is the same as the reserve increase) on the debit side, (2) adding the gross premium deferred and uncollected on the credit side, and (3) subtracting the increase in loading on the debit side—produces precisely the same result as if the whole subject of premiums deferred and uncollected had been ignored in the computation of gain from operations. The effect of the computations is simply to take one back to where one started from. It is unfortunate that the NAIC form introduces this complexity into the matter, as the writers which we have quoted in

position is, and has always been,[7] that the premiums deferred and uncollected should not be reflected in income at all until such time as they are received or there is a right to receive them, at which time they will, of course, by definition stop being "deferred and uncollected." Accordingly, it matters not whether the "loading" on the premiums deferred and uncollected will ultimately be allocated to expense or to profit. The short of the matter is that until the premiums in question are received or become receivable, the "loading" on them is not properly includible in income. When the premiums are received, then, and only

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the Petition have indicated (see n. 9, p. 8), but this long-standing peculiarity in accounting technique—which when followed through does produce the same accounting result as would obtain in an industrial corporation and under settled principles of tax accrual accounting—hardly seems a sufficient justification for the consequences which the Government would attach to it, namely, the unwarranted imposition of substantial additional taxes on the industry.

[7] The Government suggests that in the court below the position of petitioner was that the premiums deferred and uncollected were includible in income but a deduction should be allowed for the loading thereon. (Br. Op. 10) This is simply not so. The basic position of petitioner below was that the items in question did not constitute income to petitioner to be included in its statement of gain from operations. (See Plaintiff-Appellee's Brief, U. S. Court of Appeals, pp. 33-53.) The language from page 44 of that brief, quoted by the Government (Br. Op. 10), is simply from an alternative argument to the effect that if the premiums deferred and uncollected were to be included in income, a deduction should be allowed for the increase in loading. (See Pet. 17, n. 8.) Such an alternative approach was also suggested in the Court of Appeals as a method whereby that court could reach the correct result without necessarily invalidating the Government's regulation. However, contrary to the suggestion made here and elsewhere in the Government's brief (see Br. Op. 6) the petitioner is not accepting the regulation as valid; its basic position is, and always has been, that it is invalid.

Petitioner's primary position before the District Court was likewise that the items in question were not properly includible in income. The District Court's findings adopted this approach. (See Pet. App. 39a.)

then, should they be reflected in income, and if there are any proper expense deductions at that time, they will then also be taken. To the extent that the deductions then taken do not match the income reflected by the loading, there will, of course, be a net income on which petitioner will be taxable. Our position is not, once again, that the loading on premiums deferred and uncollected is a deduction. It is that premiums deferred and uncollected—in accordance with what the Government now appears to admit are conventional tax accounting principles—should not be recognized in income at all until they are received or become receivable. As we set forth in the Petition for Certiorari (pp. 7-9), the effect of the use of the NAIC form is not to recognize these amounts in income at all until the premiums are received or become receivable; the NAIC form is thus perfectly consistent in its outcome with conventional tax accounting principles.[8]

In aid of the Government's alternative position that what petitioner is trying to do is to take a deduction not provided by law, it blandly states (Br. Op. 6) that petitioner does

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[8] The weakness in the Government's position is best illustrated by n. 12, p. 14 of the Brief in Opposition, where it argues that because as a statistical matter petitioner eventually receives 95 to 98 percent of the deferred and uncollected premiums, it should accrue them forthwith. We had not previously heard it suggested that a taxpayer should be made to pay a tax in one year on what he was likely to receive the next year. The fact of the matter is that at the end of the first taxable year there is no right to receive the amounts in question and they have not been received. The fact that there is a statistical likelihood that petitioner will in fact receive the amounts in the second year is no reason for taxing them in the first; it will be time enough to tax them in the second.

It is obvious from this contention of the Government, and from the preceding discussion, that it is not petitioner who is claiming an adjustment to "indefinitely defer tax on part of petitioner's income" (Br. Op. 14), but rather that it is the Government's position that petitioner should indefinitely pay tax on amounts a year before they are received or there is any right to receive them.

not object to the inclusion in gross income of premiums deferred and uncollected. We cannot understand such a statement. The basic point of our Petition for Certiorari was to the effect that these items should not be reflected in income, and 26 pages of the petitioner's brief in the Court of Appeals were spent in argument under a caption that the pertinent amounts do "not constitute income to the plaintiff to be included in the statement of its gain from operations." See n. 7, p. 10, *supra*. —Of course, it is useful to the Government for purposes of argument to claim that there is no dispute as to inclusion in income and the real question is with respect to deductibility, but this is simply not the fact.

3. The Government next makes some effort to belittle the importance of the issues involved here by stating that it "believes" (Br. Op. 17) that we have "grossly exaggerated" the revenue consequences of the decision below. While we suppose the Government is entitled to its "beliefs," however unflattering they may be, nothing in the Brief in Opposition indicates any solid factual foundation for them. The Government's claims as to the dollar amounts involved appear to rest—to the extent that they do not rest on naked assertion—on a totally inadequate and misleading sampling of the industry. (Br. Op. 17 n. 17) The only figures which the Government has produced after four extensions of time, aggregating forty-seven extra days, in order to respond to the Petition[9] are based simply upon an examination of "the ten largest life insurance companies" in the United States. This is an absurdly

[9] These extensions were obtained by the Government in substantial part on representations that evaluation of the importance of the questions presented required the obtaining of data and information from the IRS. See letter dated December 23, 1968, from the Solicitor General to the Clerk.

narrowly based study, and its effect is grossly to overstate the amount of business in the life insurance industry done by the mutual companies.

As we pointed out in the Petition for Certiorari, the tax effect of one of the issues as to premiums deferred and uncollected is generally much more significant upon the stock insurers than upon the mutual insurers. (Pet. 21-22) While 90% of the life insurance companies in the United States are stock companies,[10] the mutual companies tend, generally speaking, to be the giants and to dominate the extreme upper end of a table of life insurance companies arranged by size. Thus, while mutual companies account for 70% of overall life-insurance-company assets and 54% of overall life insurance in force,[11] when one simply analyzes the ten largest companies in the United States, as the Government did, the ratios shift so that in the "top ten" the mutuals account for 85% of the assets and 80% of the life insurance in force.[12]

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[10] Institute of Life Insurance, *Life Insurance Fact Book* (1968), pp. 96-97.

[11] *Ibid.*

[12] In 1967, the ten largest life insurance companies in the United States accounted for $104,828,000,000 of assets, of which $90,402,000,000, or the 85% referred to in the text, was accounted for by the seven mutual companies in the top ten. In that year, the ten largest life insurance companies accounted for $561,659,000,000 in insurance in force, of which $447,774,000,000 was accounted for by the seven mutual companies, or the 80% referred to in the text.

Moreover, it is well known in the industry that the three stock companies which are in the top ten—Aetna, Connecticut General, and Travelers—write a very substantial amount of group business which is either formally participating or on which there are experience rating refunds or credits. In 1967, for the three, 86%, 69% and 75%, respectively, of premium income was from group business. *Best's Insurance Reports—Life-Health* (1968), pp. 7, 325, 1442. The result of this enormous writing of group coverage on a participating or similar basis is to create a tax profile for

The effect, then, of simply using this narrowly based selection—as opposed to the broader based samplings which we employed in the Petition (pp. 20-26)—is to exaggerate the impact of the mutual companies, to whom the issues as to premiums deferred and uncollected are somewhat less important, and thus understate the amounts of taxes involved. By using its narrow selection, the Government argues that the effect of the issues in question is only to alter the amount of taxes paid in the order of magnitude of 0.9%. On this basis, the Government concludes that the back taxes involved here are only $70,000,000. But for petitioner, a stock company, the effect of the inclusion of the additional taxes attributable to the Government's position on the issues in question for the years in suit here is to increase petitioner's taxes by 4.26%. If the Government's statistical sampling had been less biased against stock companies, we suggest that the average tax effect on an industry-wide basis of the Government's position might well have been, even as computed by the Government, in the area of an increase in taxes between 2% and 3%. Taking the Government's figures, this would mean that between $150,000,000 and $225,000,000 in

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these companies quite similar to that of a mutual company. Thus, by reason of the heavy tax deductions permitted to be taken in the computation of gain from operations, but not in the computation of taxable investment income, such companies may not have any significant excess of gain from operations over taxable investment income. See Pet. 21-22, and nn. 3 and 4, pp. 21-22. To the extent this is true, the effect of the Government's position that premiums deferred and uncollected should be reflected in gain from operations is nonexistent upon these companies. For these companies, the only effect of the Government's position is upon the asset computations used to allocate investment income between the taxable and the nontaxable shares. (Pet. 22-24)

Thus, the entire statistical "sampling" (if taking only the top ten out of 1700 can be called a "sample") employed by the Government is one which tends grossly to understate the industry-wide effect of the issues in question here.

back taxes would be involved in the issues in this case. While the Government had access—which, of course, the petitioner does not—to the tax returns of the industry, and while it obviously has made some use of them in preparing its Opposition, it is unfortunate it did not choose to analyze these returns on a broader basis.

In any event, it must be said, even on the basis which the Government has chosen to employ, there are admittedly Seventy Million Dollars in back taxes involved in the issues as to premiums deferred and uncollected. For the reasons we have indicated, the correct figures are probably much higher. But in any event, even taking the Government's word for it, there is an enormous amount of taxes involved with respect to these issues.[13]

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[13] As the Government points out, there is no conflict of appellate decisions on these issues. (Br. Op. 16) The decision below is the first appellate case on the subject. But obviously, despite the Government's efforts at a denial, there is a flat conflict between the decision below and the decision of the Tax Court in *Western National Life Insurance Co.*, 50 T.C. No. 28. See Pet. 18-20. The fact that the Tax Court in *Western National* not only rejected the Government's position, which the Court of Appeals in this case accepted, but went further than we contend for, hardly detracts from the fact that there is a conflict between the Tax Court and the Court of Appeals. The Tax Court's decision was apparently to the effect that in computing assets and liabilities, the taxpayer not only was not required to recognize as an asset the loading on premiums deferred and uncollected—which is our position—but that the taxpayer was not even required to recognize as an asset the "matching" amount, required by the NAIC form, for the premiums deferred and uncollected net of loading. It may be that this aspect of the Tax Court's decision turned on a procedural failure by the Government. In any event, our position does not go so far, but that does not mean there is no conflict.

The Government also points out that a Petition for Reconsideration is pending with respect to the Tax Court's *Western National* decision. This hardly negates the conflict. Indeed, that Petition has been pending undisposed of since last May. This does not suggest that, if left to their own devices, the lower courts will definitively resolve the issues involved here and will rapidly start closing the last eleven open years under the life insurance industry's Federal income tax returns.

4. Perhaps overcome by the size of the figures as to back taxes it is forced to admit to even under its own calculations, and by the lack of solid support for the decision below—and perhaps influenced by the fact that the issue in question affects virtually all life insurance companies and that in virtually every case all the taxable years back to 1958 have been kept open for these companies —the Government is forced into a strange admission.

That admission is that the Government would not have opposed certiorari if it appeared that granting certiorari "would facilitate the final settlement of the income tax liabilities of this and other life insurance companies." (Br. Op. 17-18) However, the Government somewhat remarkably claims that granting certiorari to resolve the issues involved here would delay the resolution of the tax liabilities of the life insurance industry generally. We find the reasoning hard to follow. The Government apparently is suggesting that if certiorari is granted, the lower courts and the tax authorities would abandon all efforts to resolve other issues which have been raised under the Act and spend their time waiting for this Court to resolve the issues at bar in this case.

The short answer is that it will obviously facilitate the overall settlement of the many open tax years of the members of the life insurance industry if this Court provides an authoritative settlement of the industry-wide issues involved here. One does not speed the resolution of all the open issues by putting off the resolution of issues as significant as the ones presented here.

We simply cannot understand how it can be contended that by leaving unresolved the important industry-wide issues here involved, it will somehow help in closing the many years which are open throughout the industry's

Federal tax returns. Taxpayers will continue to litigate the issues at bar here until they are authoritatively resolved. There is simply too much at stake for acquiescence by either side.

The Government does not take issue with the existence of the lengthy list of cases in court on this issue which we cited in our Petition (Pet. 27, n. 20)—24 in number—and it appears that there are hundreds of others at the administrative level.[14] Obviously, these issues should be resolved as promptly as possible. How denying certiorari here will assist in resolving some other issues—the Government, of course, does not say what they are or why they take precedence over the issues at bar—is obscure. Certainly denying certiorari here will not assist in resolving the issues at bar. Moreover, the Government's apparent suggestion that the Court should defer taking up the issues presented by our Petition until some sort of "supercase" is presented which poses not only them, but a number of other substantial issues to the industry, is not consistent, we suggest, with sound judicial administration either of this Court's docket or of the dockets of the lower courts.[15]

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[14] See the figures at Pet. 27-28. The Government, which should know, provides no statistics on the number of pending administrative cases.

[15] The Government claims (Br. Op. 18) that this is not a good case in which to grant certiorari because there was a finding below that the "loading" on premiums deferred and uncollected was not a reasonable estimate of future expenses. Indeed, as the Government points out, we do not contend that the loading is a reasonable estimate of future expenses; we submitted the finding in question to the District Court.

The Government seems to suggest that it would prefer that certiorari ultimately be granted in a case where the taxpayer was making the contention that the loading should be deductible as a reasonable estimate of future expenses. While we can understand the strategic considerations behind such a desire for a choice of opponents—it would be few taxpayers who would make such

II. *The Issues Respecting Unearned Interest on Policy Loans*

As to these issues, the Government does not deny that no other appellate opinion with respect to the deferral of income received but unearned sanctions a refusal to defer prepaid interest which is unearned and refundable. The Government's position on the merits on this issue is simply a stretching of the "receipt under claim of right" concept well beyond its established limits. We have discussed the merits of the question in the Petition (pp. 29-31), and little further discussion seems called for.

As we suggested in the Petition (p. 29), the Government's position is so extreme there is nothing in it to suggest that the receipt of proceeds of a loan by a taxpayer pursuant to an antecedent credit agreement would not constitute income. The loan proceeds would be received under a claim of right and without restriction as to their use. Under the Government's view, the fact that there is a corresponding liability to give the money back on the due date is evidently immaterial. But it is obviously absurd to treat the loan proceeds as income; the "receipt under claim of right" notion is not a shibboleth. As we

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an indefensible argument—we submit that the Government's preferences as to the choice of its opponents on this issue are not entitled to deference. The fact that the taxpayer here is not making the argument that the Government refers to hardly militates against the grant of certiorari.

We cannot help observing that the Government first belabors us for allegedly making the argument that the loading is a reflection of future expenses, and hence deductible (Br. Op. 11), and later (Br. Op. 18) belabors us for *not* making this argument, and for submitting a finding to the District Court that the loading on premiums deferred and uncollected is not an estimate of future expenses. Once again, it is not our position, or that of the *amicus*, that these amounts are deductible on this basis.

indicated in the Petition, with respect to prepaid interest, there is similarly a corresponding liability to give the interest back, and that liability only abates day by day as the interest is earned.

1. The Government contends that the issue is not of major significance to the life insurance industry. Once again, it follows the technique of pointing to just a few companies—the ten largest out of the approximately 1,700 in the industry. (Br. Op. 23 n. 22) According to the Government, only two out of these ten companies charged any significant interest in advance and the ten companies as a whole apparently only collected approximately $250,000 in advance interest per year; presumably it was only under a few types of policy forms that policy loan interest was charged in advance by these few companies.

But the practices of these ten companies are obviously too narrow a base from which to extrapolate any industry-wide figures for the entire industry of 1,700 companies. All the Government's figures tell us is that the policy forms used by the ten largest companies generally do not provide for charging interest in advance on policy loans. Our dollar analysis was based on a much broader sampling—the 100 largest companies—and reveals that these companies *themselves* showed in excess of $30,000,000 in unearned interest in a sample year and that, in extrapolating from them, the industry-wide figure was approximately $35,800,000 in the sample year.[16] Moreover, our question-

[16] The Government complains (Br. Op. 22-23) that our figure of $35,800,000 in annual unearned interest on policy loans contains an "inflationary element" because it includes, as well as policy loans, interest on premium notes and policy liens. Our Petition disclosed that these two other items were included, p. 11, n. 2, but pointed out that premium notes and policy liens are insignificant. Since the Government has seen fit to question this point,

naire analysis, which employed the responses from 169 companies, indicated that 73% had policies outstanding on which policy loan interest was charged in advance. (Pet. 34-35) This gives a different picture from the "top ten" which the Government cites.

With all deference to the Government, an issue can be very important to the 1,700 members of the industry even though it involves a sort of receipt of which the "top ten" giant companies do not have much. The fact remains that there is well in excess of $30,000,000 per year in unearned interest which under the Government's theory would be susceptible to taxation. The fact that this is concentrated in the companies which are somewhat smaller than the industry giants—the companies ranking from 11th through 100th—does not make the question any less important.[17]

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we have asked the American Life Convention to make an analysis, which discloses that, as of December 31, 1967, there was a total of $8,875,000,000 in policy loans among the assets of the 337 largest members of the life insurance industry, as compared to $11,383,000 in premium notes. ("Policy loans" and "premium notes" are each line items in the NAIC form statement of assets.) Only 39 of the companies had premium notes at all. Policy liens are an anachronism from the days when a number of companies were in rehabilitation proceedings, and there are so few these days that a line item is not even provided in the NAIC form for them. Accordingly, based on the comparison between the principal of policy loans and of premium notes, as indicated, it would appear that over 99.8% of the figure which we quoted in our Petition is, in fact, attributable to unearned interest on policy loans. The figure may be even higher, since it is difficult to imagine interest on premium notes being collected in advance. Accordingly, the Government's questions as to our figures are without merit.

[17] The distinction suggested by the Government between the practices of insurance companies and banks (Br. Op. 22 n. 21) does not appear to be well founded. As we developed in our Petition, it appears to be the practice of banks not simply to defer unearned interest income discounted in advance but that actually prepaid.

2. The Government seeks to rationalize the conflict of the decision below with the Seventh Circuit's decision in the *Artnell* case—which it nonetheless is quick to claim was wrongly decided[18]—on two grounds, neither of which has any merit.

(a) The Government points out that in *Artnell* there was not an absolute judgment for the taxpayer, but rather a remand to determine "whether the White Sox' method of accounting did clearly reflect its income."—The Tax Court in *Artnell* had embraced the Commissioner's *per se* rule that the income in question could not be deferred even though the taxpayer's accounting system might have properly reflected its income, and accordingly never made any finding on the issue as to whether the taxpayer's method accurately reflected its income. Hence the Court of Appeals ordered the remand.

But this does not distinguish the cases. Here there already has been a finding by the District Court that petitioner's method of accounting—day by day accrual of interest—does accurately reflect its income. (Pet. App. 49a) Of course, it is at least as clear that prepaid interest income is earned only each day as the interest period runs as that baseball season ticket revenues are earned only

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See Banking Law Journal, *Federal Income Taxation of Banks and Other Financial Institutions* (1968), ¶ 5.03(a). (Pet. 31) Moreover, the Government, embarrassed by the fact that the issue as to capitalized advance interest involves interest which has not in fact been received, proceeds to make the argument that it does not make any difference whether the amounts of advance interest have been physically received or not. (Br. Op. 19-20)

[18] During the time in which our Petition for Certiorari was pending, and the Government was considering its response, it obtained an extension of time within which to petition for certiorari in the *Artnell* case, but then chose not to file a petition for certiorari.

as each game is played. The basis on which the Court of Appeals reversed the District Court here was that, notwithstanding that the taxpayer's method of accounting did reflect its income, as a matter of law the income in question could not be deferred from the time it was received until it was earned. This is the very *per se* rule, contended for by the Government, which the panel rejected in *Artnell*.

The point of the two cases is that in *Artnell* the panel rejected the elevation of the "receipt under claim of right" doctrine to a *per se* rule notwithstanding the existence of a countervailing liability to give the money back. In the decision below, the panel embraced just such a *per se* rule.

(b) The Government also claims that the cases are distinguishable on "multiple bases". (Br. Op. 21) One basis is, it is said, that "this case does not involve dual taxpayers or a pretermitted taxable year". (Br. Op. 21) To be sure, it does not, but then nothing in the *Artnell* opinion indicates that this factor was of any decisional significance. Next it is said that "the contingencies that might cause restoration of the prepaid amounts are substantially different in nature" (Br. Op. 21); but to the extent they are, the factors are more favorable for deferral in our case.

Apparently in this connection, the Government seizes on what it calls the "peculiar fact" that the season ticket patrons in *Artnell* could secure refunds on future games "merely by demand." (Br. Op. 21) (We suppose, in addition, that the patrons would have to give their tickets back and thus relinquish their right to see the future games.) But this hardly distinguishes the cases. Here, by giving back the principal amounts they had borrowed, the

recipients of policy loans could get a refund, "merely by demand," on a per diem basis of their prepaid interest to the extent that it had not been earned. The cases are on all fours; in fact, we submit that ours is a clearer case for deferral of unearned amounts than *Artnell*.

While these issues do not have quite the enormous impact of the issues as to premiums deferred and uncollected, they are of very substantial importance to the life insurance industry. As we demonstrated in the Petition, controversies have arisen between the Government and many life insurance company taxpayers with respect to them. Our Petition reflects a broadly-based sampling of 169 life insurance companies—not just the ten selected by the Government. It indicates that 73% of the responding companies had policies outstanding on which policy loan interest was charged in advance, with 74% of these latter companies having already been challenged by the Internal Revenue Service. (Pet. 34-36)

We submit that the Government has not successfully challenged our estimate that approximately $35,800,000 annually in unearned prepaid interest is at issue, simply with respect to the additional investment income involved.[19] Indeed, even by the Government's calculations, there would be over $40,000,000 in back taxes involved on this issue for the industry's eleven open years. (Br. Op. 22) Finally, the holding of the Court of Appeals that, despite a precisely determinable obligation to make a refund of the advance unearned interest, deferral was not to be permitted, makes the decision below stand as the appellate

[19] In addition, of course, there would be a further effect on the taxes of the industry because of the inclusion of capitalized unearned prepaid interest in the assets of the companies, which would have the effect of increasing the "taxable share" of investment income.

decision rejecting deferral in the case most clearly calling for it. It is clear that there is confusion in the lower courts with respect to the application of the principles enunciated by this Court in the *Schlude* and *American Automobile Ass'n* cases which it would be appropriate for this Court to resolve at this time. These factors indicate that certiorari should be granted on these issues as well.

CONCLUSION

For the reasons stated in the Petition for Certiorari and herein, certiorari should be granted.

Respectfully submitted,

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PREME COURT
FEB 25 1969
JOHN F. DAVIS, CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1968

No. 780

THE FRANKLIN LIFE INSURANCE COMPANY,

Petitioner,

—v.—

UNITED STATES OF AMERICA,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

SUPPLEMENTAL BRIEF FOR PETITIONER

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

SUPPLEMENTAL BRIEF FOR PETITIONER

This supplemental brief is filed to call to the Court's attention an intervening decision of the Tax Court on February 24, 1969, on petition for reconsideration in the case of *Western National Life Ins. Co.*, the earlier decision in which case has been cited by the parties to the Court.

In our Petition for Certiorari (p. 19) we referred to the decision of the Tax Court in *Western National* (50 T.C., No. 28, May 13, 1968, CCH Tax Ct. Rep. § 28,954), in which the Tax Court took a position in conflict with that of the court below as to whether premiums deferred and uncollected should be included in a life insurance company's assets for the purpose of those computations to which a comparison between assets, on the one hand, and liabilities to policyholders, on the other, is pertinent.

In its Brief in Opposition, the Government (Br. Op. 16-17) called attention to the facts that: (a) the Tax Court decision was then subject to a petition for reconsideration which the Commissioner of Internal Revenue had filed on May 31, 1968, and (b) the decision of the Tax Court went further than the position we had taken, in that its decision was that premiums deferred and uncollected should be excluded altogether in the computation, and that there should not even be admitted in the computation a "matching" amount in order to wring out the reserves allocable to the premiums deferred and uncollected, which is the position which we have taken. See Petition, pp. 9-10.

As we pointed out in our Reply Brief (Rep. Br. 15 n. 13), these circumstances hardly negated the conflict between the original decision of the Tax Court and the decision of the court below. The initial decision of the Tax Court was that no part of premiums deferred and uncollected should be included in assets, and the decision of the Court of Appeals below was that the gross amount of premiums deferred and uncollected should be included in assets. However, on February 24, 1969, the Tax Court ruled on the petition for reconsideration, and, in so ruling, adopted our position *in toto*.

The Tax Court, upon petition for reconsideration, ruled that the loading on premiums deferred and uncollected should not, despite the Government's contentions, be included in a life insurance company's assets. It did, however, rule, in accordance with our position, that the premiums deferred and uncollected should be reflected in assets, pursuant to the NAIC form treatment of them, to the extent necessary to match and to "wring" out the related reserves with respect to the premiums deferred

and uncollected. A copy of the court's opinion is attached as Appendix A.[1]

Accordingly, the Tax Court has now decided one of the basic issues as to premiums deferred and uncollected completely in accordance with our position. It has also disposed of the Petition for Reconsideration filed by the Government. It has indicated its belief, so contradictory to the approach of the Government, that: "The legislative history of the Life Insurance Company Income Tax Act of 1959 indicates that Congress was attempting to tax all of a life insurance company's share of its gross income, both investment income and underwriting income, in a manner as consistent as possible with the accounting procedures required to be used by the company by State regulatory agencies."

Thus, not only does the flat conflict between the decision of the Tax Court in *Western National* and the decision

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[1] The position of the Tax Court on the question whether premiums deferred and uncollected should be reflected in gain from operations is unclear. That question was not involved in the *Western National* case. At one point in its opinion, the Tax Court appears to assume, at least *arguendo*, that premiums deferred and uncollected should be reflected in gain from operations, but then denies that it follows from that that the loading thereon should be included in assets. At another point, it appears to take the position that the loading is not includible in gain from operations until the amount of it which constitutes income is determined, *i.e.*, until the premiums are actually received and the expenses chargeable against them are incurred. Of course, the entire discussion of the gain from operations aspects of the inclusion of premiums deferred and uncollected in the Tax Court's opinion is dictum. The court's opinion does (footnote 4) contain the erroneous recital that the present petitioner conceded in the Court of Appeals that the gross premiums deferred and uncollected were to be included in gain from operations. Presumably, this assertion was due to a misstatement on the part of the Government similar to that made in its Brief in Opposition here (Br. Op. 10; see the reply in our Rep. Br. 10 n. 7), which we could not correct since we were not a party to the *Western National* case.

of the Court of Appeals below remain, but the reasons adduced by the Government why that conflict was no ground for the grant of certiorari have now been removed.

CONCLUSION

For the reasons stated in the Petition for Certiorari, our Reply Brief, and herein, certiorari should be granted.

Respectfully submitted,

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APPENDIX A

51 T. C. No. 81

TAX COURT OF THE UNITED STATES

Docket No. 1621-64.

WESTERN NATIONAL LIFE INSURANCE COMPANY OF TEXAS,

Petitioner,

—v.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Filed February 24, 1969.

Upon reconsideration,

Held: That net "deferred and uncollected premiums" and net "due and unpaid premiums" (exclusive of loading) are includable in assets for computing taxpayer's share of investment income under section 804, I.R.C. 1954, as amended. Original opinion of this Court filed May 13, 1968, reported in 50 T.C. 285, modified accordingly; affirmed on all other issues.

J. W. Bullion, for the petitioner.

John W. Holt and *Patrick W. Johnson,* for the respondent.

SUPPLEMENTAL OPINION

DRENNEN, *Judge*: Respondent filed a timely Motion for Reconsideration and Revision of the original opinion filed

by this Court in this proceeding on May 13, 1968, reported in 50 T.C. 285.[1] The motion was that the Court "modify said opinion by deciding the gross deferred and uncollected and gross due and unpaid premium asset issues (Issues Nos. 2, 3, and 4 in the Opinion) in accord with the contention of the respondent." Respondent's motion was set down for oral argument on August 7, 1968, and the Court invited counsel[2] for the American Life Convention and the Life Insurance Association of America to participate as amici curiae. In addition to the oral argument, extensive briefs were filed by the amici curiae as well as by petitioner and respondent. In the light of the arguments presented, and the decision of the United States Court of Appeals for the Seventh Circuit in *Franklin Life Insurance Co.* v. *United States,* 399 F.2d 757, certiorari applied for Nov. 27, 1968, promulgated subsequent to the original opinion of this Court, we deemed it appropriate to reconsider the two issues mentioned above and to revise our opinion as a result thereof. Consequently, respondent's Motion for Reconsideration and Revision was granted.

This Court made complete findings of fact and reviewed the provisions of the Code which are pertinent to the issues here under review in its original opinion and will not repeat them here. Reference is made to the former opinion of this Court, *supra,* for the facts involved in this proceeding.

The only issues before the Court involved adjustments proposed by respondent in the computation of petitioner's

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[1] Respondent also filed a Request for Review by Full Court, which is denied.

[2] *William B. Harman, Jr.,* for American Life Convention.
Kenneth L. Kimble, for Life Insurance Association of America.

so-called phase I tax, or tax on investment income, imposed under the Life Insurance Company Income Tax Act of 1959, section 801, *et seq.*, of the 1954 Code as amended. In its original opinion the Court agreed with petitioner and held that "deferred and uncollected premiums" and "due and unpaid premiums" were not to be included as "assets" within the meaning of section 805(b)(4) of the Code,[3] in computing petitioner's share (and the policyholders' share) of its investment income under the formula provided for that purpose in section 804. The basic premise upon which the Court based this conclusion was that there should be included in assets for purposes of the computation only such assets as produced the net investment income, and that these bookkeeping assets, not being available to petitioner, should be excluded.

Respondent contends that the entire gross amount of the "deferred and uncollected premiums" and the "due and unpaid premiums," including "loading," should be included in assets for purposes of the computation. The amici agree with respondent that "deferred and uncollected premiums" should be included in assets to avoid distortion in the computation under the prescribed formula, but that the loading should not be included. The amici took no position with respect to "due and unpaid premiums."

Upon further reflection, we agree with the amici that the net "deferred and uncollected premiums" should be included in assets but that the "loading" included in such premiums should not be included; also we conclude that

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[3] These terms are defined in the original opinion. Briefly, "deferred and uncollected premiums" are premiums that will become due by the end of the contract year on life insurance contracts but which are not collected by the end of petitioner's tax (calendar) year, and "due and unpaid premiums" are premiums on accident and health insurance contracts that are due but have not been paid at the end of petitioner's tax year.

the net "due and unpaid premiums" should be included in assets but that the loading included in such premiums should not be included. Accordingly, the original opinion of this Court, *supra,* is modified to reflect the views herein expressed with respect to those two issues, and the conclusions reached therein with respect to all other issues involved are hereby affirmed.

The legislative history of the Life Insurance Company Income Tax Act of 1959 indicates that Congress was attempting to tax all of a life insurance company's share of its gross income, both investment income and underwriting income, in a manner as consistent as possible with the accounting procedures required to be used by the company by State regulatory agencies. This involves accepting the assumption, even though it has no basis in fact, that in establishing its reserves for policyholder liabilities in the taxable year the insurance company must assume that the gross annual premiums on all policies in force at the end of the year have been paid in full. Thus the net valuation premiums, i.e., the gross premiums less the loading factor, on all policies in force at the end of the year are added to the company's reserves and are shown on its balance sheet as liabilities. In order to avoid a distorted balance sheet resulting from setting up this admittedly overstated reserve as a liability, the insurance company is permitted to include in its balance sheet as an offsetting asset the items "deferred and uncollected premiums" and "due and unpaid premiums," which are likewise fictitious assets. As with the liability, the amount to be included on the asset side of the balance sheet on the National Association of Insurance Commissioners (NAIC) forms is the net valuation portion of the premiums, exclusive of loading.

In the scheme of taxing the insurance company's share of its investment income under phase I of the tax, the reserves above mentioned are used to measure the policyholders' share of its investment income. The policyholders' reserves are multiplied by the company's own current or average investment rate to obtain the policyholders' share of the investment yield, which is nontaxable; the balance of the investment yield is the company's share of net investment income which is subject to tax under phase I.

In arriving at the company's current investment rate, certain expenses are deducted from its gross investment income to obtain the investment yield. The investment yield is then divided by the assets of the company to obtain the current rate. The company assets used in this computation are defined in section 805(b)(4) as all the assets of the company other than real and personal property (excluding money) used by it in carrying on an insurance trade or business. Inasmuch as the fictitious assets "deferred and uncollected premiums" and "due and unpaid premiums" are not assets used by the company in carrying on its insurance business, it would seem that these "assets" must be included in the computation used in finding the company's current rate, even though they are not real assets and could not possibly be used to produce investment income.

While it is difficult to understand how amounts which neither have been received nor are due and collectible as of the end of an accounting year can be considered accruable in the usual accounting sense of that term, it is easier to understand that if one starts with the *assumption* that these amounts have all been paid by the end of the year, they would certainly be accrued if the assumption is accepted as fact. It is also easier to understand that if the objective of the phase I tax is to exclude from the tax on

investment income the policyholders' share of that income, and in order to arrive at the amount of that exclusion the measurement used is an amount (the reserves) which includes in it net valuation premiums which are assumed to have been paid in full, it would thereby become necessary, in order to avoid distortion in this scheme of taxation, to likewise assume that all net valuation premiums have been collected and are "accrued" assets in the company's hands for purposes of determining the current rate and the company's share of the investment income or yield that is subject to tax. In other words, it is easier to leave for the moment the practicalities of taxation to include in both sides of a formula used for apportioning investment income between the company and its policyholders equal and offsetting fictitious amounts than to accept the theory that uncollected premiums that are not even due can be considered "assets" which produce investment income. To do otherwise would appear to throw the formula out of balance and distort the proration.

While we find no specific support for this conclusion in the legislative history of the Act, this fiction appears to be accepted by all parties here concerned as a part of the scheme for taxing insurance companies under the 1959 Act, and the Court of Appeals for the Seventh Circuit accepted it in its opinion in *Franklin Life Insurance Co., supra.* Inasmuch as the insurance industry operates a good bit on assumptions, perhaps this is the only reasonable approach to the problem. In any event we are not convinced that net "deferred and uncollected premiums" and "due and unpaid premiums" must be included in assets in computing petitioner's tax under phase I of the Act, and our former opinion holding to the contrary is modified in this respect.

This does not answer the issue entirely, however. There still remains the question whether the loading factor included in "deferred and uncollected premiums" and "due and unpaid premiums" must be included in these fictitious assets. Respondent argues that "loading" should be included, and he is supported in this position by the Court of Appeals in the *Franklin* case, and by the District Court in *Jefferson Standard Life Insurance Co.* v. *United States*, 272 F.Supp. 97 (M.D. N.C. 1967), which is now on appeal to the Court of Appeals for the Fourth Circuit. Petitioner and the amici curiae argue that the loading factor should not be included in assets because it has a zero basis and to include the entire gross amount of the premiums in assets while only the net valuation part thereof (gross premiums minus loading) is included in reserves would weight the formula against the insurance company and distort the balance sheet and the computation the other way. With all due respect to the Court of Appeals for the Seventh Circuit and the District Court in North Carolina, we must agree with petitioner and the amici.

The reasoning of the Court of Appeals and the argument of respondent is that in computing phase II of the tax on petitioner's underwriting or operating income under section 809, petitioner is required to take into account as "gain from operation" the gross amount of premiums and other consideration (including advance premiums, deposits, fees, assessments, and consideration in respect of assuming liabilities under contracts not issued by the taxpayer) on insurance and annuity contracts, less return premiums, and the premiums and other consideration arising out of reinsurance ceded.[4] Again using the assumption that all premiums on policies in force at the

[4] This was conceded by the taxpayer in *Franklin Life Insurance Co.*, 399 F.2d 757.

end of the year have been paid in full by the end of the year, the "deferred and uncollected premiums" and "due and unpaid premiums," including the loading factor therein, are considered to be accrued income for the purpose of this computation. (This, despite the fact that the statute expressly includes "advance premiums, deposits, fees," etc., but says nothing about deferred and unpaid premiums.) The argument then points out that the statute does not allow any deduction for loading; hence the entire amount of the gross premiums becomes an "accrued" asset.

We do not believe it necessarily follows that because loading is required to be included in gross premiums and is not deductible in the computation of the phase II tax, it must also be included in assets for computation of the phase I tax. As we understand it the phase II computation is designed to tax the insurance companies' gain on operating income including gain on the very charges we are discussing, i.e., the loading charges. There is no question that any gain on such charges is intended to be taxed to the insurance company, either in the year of "accrual" or when actually realized. On the other hand the only reason for including deferred and unpaid premiums as balance sheet assets for purposes of the phase I tax is to offset the overstated reserves and prevent distortion in computing the policyholders' and the insurance companies' shares of investment yield. We see no reason when indulging in this fiction to set up, or accrue, an asset greater in amount than is necessary to offset the overstated liability on the other side of the balance sheet. To do so would simply swing the pendulum the other way and distort the allocation against the petitioner.

We find nothing in section 818(a) that requires a different conclusion. That section provides that all computa-

tions entering into the determination of the taxes imposed by this law shall be made (1) under an accrual method of accounting, or (2) to the extent permitted under the regulations prescribed by the Secretary or his delegate, under a combination of an accrual method of accounting with any other method permitted by this chapter, except the cash method. Except as provided in the preceding sentence, all such computations shall be made in a manner consistent with the manner required for the purposes of the annual statement by the National Association of Insurance Commissioners.

As pointed out in our prior opinion, the deferred and unpaid premiums would not be accrued under standard accrual accounting concepts, because they were not received by the end of the year and were not collectible unless the insured agreed to pay them. They could be considered accrued, and thus give rise to an accrued asset, only if the assumption is made that all premiums on policies in force had been paid by the end of the year. If this assumption is indulged in for this purpose, we think it should also be assumed that all commissions and other expenses covered by the loading charge had been paid by the end of the year, leaving only the net valuation amount as the value of the asset. We recognize that if the loading charge exceeds the expenses chargeable against it, there might be some of the loading charge left available as a fictitious asset. However, that gain would eventually be taxed under phase II of the tax and we see no reason to include it as an asset for purposes of the phase I computation until the amount thereof can be determined. Furthermore, if the loading factor must be considered an accrued asset under the assumptions indulged in, we doubt that it would be an asset other than property used by it

in carrying on an insurance trade or business under the definition contained in section 805(b)(4).

We find nothing in the definition of assets in section 805(b)(4) that specifically includes loading. The NAIC accounting excludes it from assets. And we would not know what adjusted basis, if any, to attribute to this item in any event it it were included in assets.

Consequently, we conclude that "loading" on "deferred and uncollected premiums" and on "due and unpaid premiums" is not includable in assets under section 805(b)(4) of the Code.

Respondent urges that under section 1.801-4(f) of his regulations[5] if petitioner is permitted to exclude any part of gross premiums deferred and uncollected and due and unpaid from assets, then a corresponding portion of the net valuation premium must be excluded from the reserves used in the tax computation. The only portion of the accrued gross premiums excluded from assets is the loading factor, which never becomes a part of the reserves used for purposes of this computation. We do not believe any further adjustment either should be made or is called for by the regulations.

In his memorandum filed in support of this motion, respondent argues that if loading is omitted from assets (deducted from "accrued" gross premiums) for purposes of the computation of the phase I tax petitioner would in effect get a double deduction for the expenses supposedly

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[5] Sec. 1.801-4(f). *Adjustments to life insurance reserves.* In the event it is determined on the basis of the facts of a particular case that premiums deferred and uncollected and premiums due and unpaid are not properly accruable for the taxable year under section 809 and, accordingly, are not properly includible under assets (as defined in section 805(b)(4)) for the taxable year, appropriate reduction shall be made in the life insurance reserves. * * *

covered by the loading factor when the phase II tax is computed. We do not agree with respondent's reasoning in this argument, but we are happy to say that we have no issue before us concerning the phase II tax and we choose not to venture further than need be into this fantasy world of life insurance company accounting and taxation.

Except as modified herein, the conclusions reached in our prior opinion stand affirmed.

In the Supreme Court of the United States

OCTOBER TERM, 1968

No. 780

THE FRANKLIN LIFE INSURANCE COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

SUPPLEMENTAL MEMORANDUM ON BEHALF OF THE UNITED STATES

Pursuant to Rule 24(5) of the Rules of this Court, we file this memorandum to inform the Court that the Tax Court, on February 24, 1969, issued a supplemental opinion in *Western National Life Insurance Co. of Texas* v. *Commissioner*, 51 T.C. No. 81, modifying 50 T.C. 285. A copy of the supplemental opinion is printed as an appendix hereto.

The petition for a writ of certiorari asserted (p. 19) that the original opinion in *Western National* was in conflict with the decision of the Seventh Circuit here. As stated in our Brief in Opposition (p. 16), *Western National* had not yet become final, having

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been held open on the Commissioner's motion for reconsideration.

In the opinion of February 24, the Tax Court adopted the position of petitioner on the question whether the amount described as "loading" should be subtracted in determining the amount of deferred and uncollected premium included in the "assets" of life insurance companies in the "phase I" computation under Section 805(b)(4).[1] The opinion expressly reserves, however, the other premium question presented in the instant case, *i.e.*, whether the amount which petitioner calls "increase in loading" should be excluded from the deferred and uncollected portion in "gross premiums" in the "phase II" computation under Section 809(c)(1). Thus the opinion states (App. p. 12):

> We do not believe it necessarily follows that because loading is required to be included in gross premiums and is not deductible in the computation of the phase II tax, it must also be included in assets for computation of the phase I tax. As we understand it the phase II computation is designed to tax the insurance companies' gain on operating income including gain on the very charges we are discussing, i.e., the loading charges. There is no question that any gain on such charges is intended to be taxed to the insurance company, either in the year of "accrual" or when actually realized.

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[1] The motion for reconsideration of the original decision was accompanied by a request for review by the full Tax Court. By footnote to the supplemental opinion, Chief Judge Drennen denied the request for review by the full Tax Court (App. p. 5).

For the reasons stated in our Brief in Opposition (pp. 9–18) we adhere to the view that the Seventh Circuit correctly held that the full amount of premiums deferred and uncollected should be included both in premium income and in assets without an offset for the amounts described as "loading". And we are unable to perceive a rational basis for the treatment suggested by the language quoted above from the supplemental opinion in *Western National*, *i.e.*, that an adjustment for loading may be allowed in calculating assets but not in determining gain from operations.

At all events, the disagreement between the Tax Court and the Seventh Circuit does not give rise to a conflict in decisions that independently justifies review in this Court. The decision in *Western National* remains subject to appellate review, which, in due course, would occur in the Court of Appeals for the Fifth Circuit. Plenary consideration in this Court should await the development of a conflict of opinion among the circuits if one should ultimately occur.

Respectfully submitted.

ERWIN N. GRISWOLD,
Solicitor General.

FEBRUARY 1969.

APPENDIX

51 T.C. No. 81

TAX COURT OF THE UNITED STATES

WESTERN NATIONAL LIFE INSURANCE COMPANY OF TEXAS, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 1621–64 Filed February 24, 1969.

Upon reconsideration,

Held: That net "deferred and uncollected premiums" and net "due and unpaid premiums" (exclusive of loading) are includable in assets for computing taxpayer's share of investment income under section 804, I.R.C. 1954, as amended. Original opinion of this Court filed May 13, 1968, reported in 50 T.C. 285, modified accordingly; affirmed on all other issues.

J. W. Bullion, for the petitioner.

John W. Holt and *Patrick W. Johnson,* for the respondent.

SUPPLEMENTAL OPINION

DRENNEN, *Judge:* Respondent filed a timely Motion for Reconsideration and Revision of the original opinion filed by this Court in this proceeding on May 13, 1968, reported in 50 T.C. 285.[1] The motion was that the Court "modify said opinion by deciding the gross deferred and uncollected and gross due and unpaid

[1] Respondent also filed a Request for Review by Full Court, which is denied.

premium asset issues (Issues Nos. 2, 3, and 4 in the Opinion) in accord with the contention of the respondent." Respondent's motion was set down for oral argument on August 7, 1968, and the Court invited counsel [2] for the American Life Convention and the Life Insurance Association of America to participate as amici curiae. In addition to the oral argument, extensive briefs were filed by the amici curiae as well as by petitioner and respondent. In the light of the arguments presented and the decision of the United States Court of Appeals for the Seventh Circuit in *Franklin Life Insurance Co.* v. *United States*, 399 F. 2d 757, certiorari applied for Nov. 27, 1968, promulgated subsequent to the original opinion of this Court, we deemed it appropriate to reconsider the two issues mentioned above and to revise our opinion as a result thereof. Consequently, respondent's Motion for Reconsideration and Revision was granted.

This Court made complete findings of fact and reviewed the provisions of the Code which are pertinent to the issues here under review in its original opinion and will not repeat them here. Reference is made to the former opinion of this Court, *supra*, for the facts involved in this proceeding.

The only issues before the Court involved adjustments proposed by respondent in the computation of petitioner's so-called phase I tax, or tax on investment income, imposed under the Life Insurance Company Income Tax Act of 1959, section 801, *et seq.*, of the 1954 Code as amended. In its original opinion the Court agreed with petitioner and held that "deferred and uncollected premiums" and "due and unpaid premiums" were not to be included as "assets" within the

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[2] *William B. Harman, Jr.*, for American Life Convention.
Kenneth L. Kimble, for Life Insurance Association of America.

meaning of section 805(b)(4) of the Code,[3] in computing petitioner's share (and the policyholders' share) of its investment income under the formula provided for that purpose in section 804. The basic premise upon which the Court based this conclusion was that there should be included in assets for purposes of the computation only such assets as produced the net investment income, and that these bookkeeping assets, not being available to petitioner, should be excluded.

Respondent contends that the entire gross amount of the "deferred and uncollected premiums" and the "due and unpaid premiums," including "loading," should be included in assets for purposes of the computation. The amici agree with respondent that "deferred and uncollected premiums" should be included in assets to avoid distortion in the computation under the prescribed formula, but that the loading should not be included. The amici took no position with respect to "due and unpaid premiums."

Upon further reflection, we agree with the amici that the net "deferred and uncollected premiums" should be included in assets but that the "loading" included in such premiums should not be included; also we conclude that the net "due and unpaid premiums" should be included in assets but that the loading included in such premiums should not be included. Accordingly, the original opinion of this Court, *supra,* is modified to reflect the views herein expressed with

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[3] These terms are defined in the original opinion. Briefly, "deferred and uncollected premiums" are premiums that will become due by the end of the contract year on life insurance contracts but which are not collected by the end of petitioner's tax (calendar) year, and "due and unpaid premiums" are premiums on accident and health insurance contracts that are due but have not been paid at the end of petitioner's tax year.

respect to those two issues, and the conclusions reached therein with respect to all other issues involved are hereby affirmed.

The legislative history of the Life Insurance Company Income Tax Act of 1959 indicates that Congress was attempting to tax all of a life insurance company's share of its gross income, both investment income and underwriting income, in a manner as consistent as possible with the accounting procedures required to be used by the company by State regulatory agencies. This involves accepting the assumption, even though it has no basis in fact, that in establishing its reserves for policyholder liabilities in the taxable year the insurance company must assume that the gross annual premiums on all policies in force at the end of the year have been paid in full. Thus the net valuation premiums, i.e., the gross premiums less the loading factor, on all policies in force at the end of the year are added to the company's reserves and are shown on its balance sheet as liabilities. In order to avoid a distorted balance sheet resulting from setting up this admittedly overstated reserve as a liability, the insurance company is permitted to include in its balance sheet as an offsetting asset the items "deferred and uncollected premiums" and "due and unpaid premiums," which are likewise fictitious assets. As with the liability, the amount to be included on the asset side of the balance sheet on the National Association of Insurance Commissioners (NAIC) forms is the net valuation portion of the premiums, exclusive of loading.

In the scheme of taxing the insurance company's share of its investment income under phase I of the tax, the reserves above mentioned are used to measure the policyholders' share of its investment income. The policyholders' reserves are multiplied by the company's

own current or average investment rate to obtain the policyholders' share of the investment yield, which is nontaxable; the balance of the investment yield is the company's share of net investment income which is subject to tax under phase I.

In arriving at the company's current investment rate, certain expenses are deducted from its gross investment income to obtain the investment yield. The investment yield is then divided by the assets of the company to obtain the current rate. The company assets used in this computation are defined in section 805(b)(4) as all the assets of the company other than real and personal property (excluding money) used by it in carrying on an insurance trade or business. Inasmuch as the fictitious assets "deferred and uncollected premiums" and "due and unpaid premiums" are not assets used by the company in carrying on its insurance business, it would seem that these "assets" must be included in the computation used in finding the company's current rate, even though they are not real assets and could not possibly be used to produce investment income.

While it is difficult to understand how amounts which neither have been received nor are due and collectible as of the end of an accounting year can be considered accruable in the usual accounting sense of that term, it is easier to understand that if one starts with the *assumption* that these amounts have all been paid by the end of the year, they would certainly be accrued if the assumption is accepted as fact. It is also easier to understand that if the objective of the phase I tax is to exclude from the tax on investment income the policyholders' share of that income, and in order to arrive at the amount of that exclusion the measurement used is an amount (the reserves) which includes in it net valuation premiums

which are assumed to have been paid in full, it would thereby become necessary, in order to avoid distortion in this scheme of taxation, to likewise assume that all net valuation premiums have been collected and are "accrued" assets in the company's hands for purposes of determining the current rate and the company's share of the investment income or yield that is subject to tax. In other words, it is easier to leave for the moment the practicalities of taxation to include in both sides of a formula used for apportioning investment income between the company and its policyholders equal and offsetting fictitious amounts than to accept the theory that uncollected premiums that are not even due can be considered "assets" which produce investment income. To do otherwise would appear to throw the formula out of balance and distort the proration.

While we find no specific support for this conclusion in the legislative history of the Act, this fiction appears to be accepted by all parties here concerned as a part of the scheme for taxing insurance companies under the 1959 Act, and the Court of Appeals for the Seventh Circuit accepted it in its opinion in *Franklin Life Insurance Co., supra.* Inasmuch as the insurance industry operates a good bit on assumptions, perhaps this is the only reasonable approach to the problem. In any event we are now convinced that net "deferred and uncollected premiums" and "due and unpaid premiums" must be included in assets in computing petitioner's tax under phase I of the Act, and our former opinion holding to the contrary is modified in this respect.

This does not answer the issue entirely, however. There still remains the question whether the loading factor included in "deferred and uncollected premiums" and "due and unpaid premiums" must be

included in these fictitious assets. Respondent argues that "loading" should be included, and he is supported in this position by the Court of Appeals in the *Franklin* case, and by the District Court in *Jefferson Standard Life Insurance Co.* v. *United States*, 272 F. Supp. 97 (M.D.N.C. 1967), which is now on appeal to the Court of Appeals for the Fourth Circuit. Petitioner and the amici curiae argue that the loading factor should not be included in assets because it has a zero basis and to include the entire gross amount of the premiums in assets while only the net valuation part thereof (gross premiums minus loading) is included in reserves would weight the formula against the insurance company and distort the balance sheet and the computation the other way. With all due respect to the Court of Appeals for the Seventh Circuit and the District Court in North Carolina, we must agree with petitioner and the amici.

The reasoning of the Court of Appeals and the argument of respondent is that in computing phase II of the tax on petitioner's underwriting or operating income under section 809, petitioner is required to take into account as "gain from operation" the gross amount of premiums and other consideration (including advance premiums, deposits, fees, assessments, and consideration in respect of assuming liabilities under contracts not issued by the taxpayer) on insurance and annuity contracts, less return premiums, and the premiums and other consideration arising out of reinsurance ceded.[4] Again using the assumption that all premiums on policies in force at the end of the year have been paid in full by the end of the year, the

[4] This was conceded by the taxpayer in *Franklin Life Insurance Co.*, 399 F. 2d 757.

"deferred and uncollected premiums" and "due and unpaid premiums," including the loading factor therein, are considered to be accrued income for the purpose of this computation. (This, despite the fact that the statute expressly includes "advance premiums, deposits, fees," etc., but says nothing about deferred and unpaid premiums.) The argument then points out that the statute does not allow any deduction for loading; hence the entire amount of the gross premiums becomes an "accrued" asset.

We do not believe it necessarily follows that because loading is required to be included in gross premiums and is not deductible in the computation of the phase II tax, it must also be included in assets for computation of the phase I tax. As we understand it the phase II computation is designed to tax the insurance companies' gain on operating income including gain on the very charges we are discussing, i.e., the loading charges. There is no question that any gain on such charges is intended to be taxed to the insurance company, either in the year of "accrual" or when actually realized. On the other hand the only reason for including deferred and unpaid premiums as balance sheet assets for purposes of the phase I tax is to offset the overstated reserves and prevent distortion in computing the policyholders' and the insurance companies' shares of investment yield. We see no reason when indulging in this fiction to set up, or accrue, an asset greater in amount than is necessary to offset the overstated liability on the other side of the balance sheet. To do so would simply swing the pendulum the other way and distort the allocation against the petitioner.

We find nothing in section 818(a) that requires a different conclusion. That section provides that all computations entering into the determination of the taxes imposed by this law shall be made (1) under an

accrual method of accounting, or (2) to the extent permitted under the regulations prescribed by the Secretary or his delegate, under a combination of an accrual method of accounting with any other method permitted by this chapter, except the cash method. Except as provided in the preceding sentence, all such computations shall be made in a manner consistent with the manner required for purposes of the annual statement by the National Association of Insurance Commissioners.

As pointed out in our prior opinion, the deferred and unpaid premiums would not be accrued under standard accrual accounting concepts, because they were not received by the end of the year and were not collectible unless the insured agreed to pay them. They could be considered accrued, and thus give rise to an accrued asset, only if the assumption is made that all premiums on policies in force had been paid by the end of the year. If this assumption is indulged in for this purpose, we think it should also be assumed that all commissions and other expenses covered by the loading charge had been paid by the end of the year, leaving only the net valuation amount as the value of the asset. We recognize that if the loading charge exceeds the expenses chargeable against it, there might be some of the loading charge left available as a fictitious asset. However, that gain would eventually be taxed under phase II of the tax and we see no reason to include it as an asset for purposes of the phase I computation until the amount thereof can be determined. Furthermore, if the loading factor must be considered an accrued asset under the assumptions indulged in, we doubt that it would be an asset other than property used by it in carrying on an insurance trade or business under the definition contained in section 805(b)(4).

We find nothing in the definition of assets in section 805(b)(4) that specifically includes loading. The NAIC accounting excludes it from assets. And we would not know what adjusted basis, if any, to attribute to this item in any event if it were included in assets.

Consequently, we conclude that "loading" on "deferred and uncollected premiums" and on "due and unpaid premiums" is not includable in assets under 805(b)(4) of the Code.

Respondent urges that under section 1.801-4(f) of his regulations [5] if petitioner is permitted to exclude any part of gross premiums deferred and uncollected and due and unpaid from assets, then a corresponding portion of the net valuation premium must be excluded from the reserves used in the tax computation. The only portion of the accrued gross premiums excluded from assets is the loading factor, which never becomes a part of the reserves used for purposes of this computation. We do not believe any further adjustment either should be made or is called for by the regulations.

In his memorandum filed in support of this motion, respondent argues that if loading is omitted from assets (deducted from "accrued" gross premiums) for purposes of the computation of the phase I tax petitioner would in effect get a double deduction for the expenses supposedly covered by the loading

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[5] Sec. 1.801-4(f). *Adjustments to life insurance reserves.* In the event it is determined on the basis of the facts of a particular case that premiums deferred and uncollected and premiums due and unpaid are not properly accruable for the taxable year under section 809 and, accordingly, are not properly includible under assets (as defined in section 805(b)(4)) for the taxable year, appropriate reduction shall be made in the life insurance reserves. * * *

factor when the phase II tax is computed. We do not agree with respondent's reasoning in this argument, but we are happy to say that we have no issue before us concerning the phase II tax and we choose not to venture further than need be into this fantasy world of life insurance company accounting and taxation.

Except as modified herein, the conclusions reached in our prior opinion stand affirmed.

U. S. GOVERNMENT PRINTING OFFICE: 1969